

Governor Ignazio Visco Interview with La Repubblica, EL PAIS, LE FIGARO, Die Welt, members of the Leading European Newspaper Alliance – LENA

Rome, 18 June 2016

“Brexit is the most difficult challenge facing the EU”

Brexit is the most difficult challenge facing the EU. What are the economic and political consequences? Are there contingency plans to tackle a possible financial crisis?

Visco: Obviously, the risk of a “leave” outcome in the coming referendum is what we are most concerned about. We are already seeing the effects of this risk in the currency and bond markets. It is clear that such an outcome would have material consequences in the short- and long-term. There are many estimates that have been considered. If an exit takes place, it does not take place from one day to the other, it is a long process of negotiation, involves regulatory and legal issues and it will certainly have financial consequences, but it is difficult to predict how large. We are looking at it day by day, we are looking at the consequences on the markets. All central banks, and not just the ECB, are ready to intervene with the standard tools that we have: repos, swaps, interest rates. This is the standard toolbox. But the concern is not only economic and financial. It is clearly also a concern on the political strength of the European construction and how this will be maintained and fostered, because fostering it will be a necessity, in any case, but especially if there is an exit. We are looking at it carefully, we are concerned, but with a clear mind.

Will Brexit mean the end of the European construction?

Visco: It means that in order for it not to be an end, we have to foster integration. There is an Italian say, illustrative of the situation after the Unification of the country 150 years ago, saying “fatta l’Italia, bisogna fare gli Italiani” (We have made Italy. Now we must make Italians).

Do you think there is appetite to foster the project? Policy makers such as the president of the European Council, Donald Tusk, are sending the opposite message, and we have elections in Germany and France...

Visco: The danger is that there is a slowing down. This is why we have to go further. There is a mistake in many minds: that most, if not all, social, economic, political issues could be better sorted out at the national level, rather than at the European level. This is deeply wrong: think about migration, security, these are issues that can only be sorted out at the continental level. We should start from particular political decision, which does not mean following the utopian concept of United States of Europe. It means taking concrete steps in the political field.

Where has the European construction failed? What errors can be attributed to Europe?

Visco: A possible Brexit has nothing to do with errors in the construction. It has to do with a sentiment of mistrust that unfortunately is taking place in Europe and the worries of geopolitical risks. Perhaps, leaders, all of us, have not been able to explain how important is to go beyond the national dimension to deal with these risks. Obviously, we may say that as far as the euro-area is concerned, after this was created it has taken too long to move ahead, and we needed a major crisis to go in the direction of strengthening the EU. Short-sightedness is not limited to market participants, it is something that characterizes, sometimes understandably so, also those who are elected.

If there were a Brexit, Italy may be in the firing line of the markets. There has already been a slight widening of sovereign spreads between Italian and German bonds and there are fears that the value of bank shares may fall further. Do you share these concerns?

Visco: The increase in spreads is due to a reduction in interest rates in Germany, the price of Italy's debt has remained more or less unchanged. Bank shares are already falling. The risk of Brexit has an effect on volatility in markets in general. If you look at bank shares, these reflect concerns on the non performing loans, which we think are important and we consider with appropriate care. Also, usually there is overshooting by the markets in these instances.

For Italian banks, is the issue Brexit or credit quality?

Visco: For the banks, the issue is one of growth, the ability of the economy to recover sufficient speed. This is also the problem for the public debt. It is an issue of whether banks will be able to recover from excessively high bad loans. These bad loans may have an effect on certain banks, but in most cases they simply imply that bank profits will have to be lower than operating income in order to compensate for the losses that may come from NPLs. Consider not only that these NPLs have been already in good part written down in the balance sheets of banks, but also that they have guarantees that over time, in most cases, will cover the exposures. The problem is when a bank is in a state of difficulty and has to address the issue quickly. This is why we needed and need instruments to take care of this condition...

Even if Brexit happens, what immediate steps should Europe take to prevent this from happening again?

Visco: Obviously, you first need to shield from excessive panic. This has to be taken seriously, but it has not to be seen as the end of the world. The European construction has dealt with the UK cyclically. There is a genuine difficulty in this. Politicians have to be able to go back to the fundamental values that are behind the European construction, and make it clear what these values are. The reason for the mistrust among European public opinions and leaders is, at the root, the consequence of uncertainty. We live in a much more uncertain world and uncertainty is something that delays investment, that tends to raise savings and the two together produce lower income, and lower income leads to fewer jobs. Technological change is seen as something that is very much affecting the possibility of maintaining jobs as they used to be in the last decade: there are also opportunities, but the transition is complex. All of this is wrongly attributed to the euro. It is important to make it clear the euro is not the reason for the difficulties we face. It is complex to address these difficulties: in the banking sector, we have fewer tools that we used to have; there are effects on income distribution and poverty that are more serious that we want to admit; the issue of migration or refugees cannot be addressed only from a humanitarian perspective, that is fundamental, but with a more rational view and with common tools. This needs trust.

Let us move to monetary policy. Will you support an extension of quantitative easing beyond March 2017?

Visco: It depends from what we see. We always say that an extension is conditional. My view is that we are proceeding in the right direction and we have taken all the steps needed. Some say there is no deflation risk, but the reason why there is no deflation risk is because we have taken certain measures. Those who were objecting the measures before should thank those who have pushed for the measures in the first place. Jens Weidmann and others are right in saying that monetary policy is not and cannot be the only game in town. Monetary policy alone cannot bring the needed growth that will take us out of the crisis. Monetary policy is a very powerful tool, most powerful when there is inflation: it has to be used and it has been used. But it has to be used also when there is excessively low inflation, in line with the objective of maintaining price stability, which also means avoiding the disanchoring of expectations from the objective. After a prolonged period of too low or negative inflation, sooner or later expected inflation falls and real interest rates go up. Given the high public and private debt levels we have in our economies, this is a very risky situation. This is why we are taking these measures. Financial stability is favoured by these measures. Some say that asset prices may go up because of the very low interest rates and cause financial instability. My point is that if we avoid bankruptcies, failures and defaults, we go a long way to preserve financial stability. Of course, we look very carefully at the developments in asset markets.

The ECB is now buying corporate bonds. Does this mean central banks are now affecting industrial policy?

Visco: The first criticism was that we were getting into fiscal policy, now that we are involved in industrial policy. No, neither the first, nor the second. These are the instruments to create base money and what is more conventional for a central bank than to create the monetary base? We are very careful however with regard to prices, because we understand there may be unintended effects, so we have limits on issuances, the quality of issuers, we have benchmarks to assess the market neutrality of the measures.

Are you saying that the economic policy mix in the eurozone has been a mistake? The US has recovered much faster with a different combination from the one in Europe.

Visco: It is a difficult question to answer. The Eurozone started from a very different situation than the US. The US had a financial crisis and this financial crisis became a global financial crisis. It was a crisis of very large investment banks. The major public sector move in the US was intervening in the banking sector with TARP. In our case, the crisis was related in particular to the recession that followed the financial crisis. It was a crisis of particular markets, such as the housing market in Ireland and Spain, it was a crisis of competitiveness and growth, for example in Italy, and it was a crisis of playing with deficit and debt figures in other cases. All of this had an impact for the sovereigns. The issue is whether we dealt with it with the proper instruments. Unfortunately we lacked the governance instruments in Europe. As governance was strengthened – with the fiscal rules, the ESM and the banking union – and monetary policy played its part also to reduce the redenomination risk, countries which had excessive deficit increases and a build up of debt had to exercise fiscal restraint. It was different from the US. The problem was that the confidence effects that could be linked to the fiscal restraint were not strong enough to encourage investment, which was the variable that could have helped in the recovery, both for demand and supply. Why was there not a bigger boost in confidence? Perhaps, investors did not believe that the combination of a restrictive fiscal policy and structural reforms could determine an increase in demand. This has to be studied by historians. We have to look forward and say that monetary policy cannot be alone and must be complemented by growth-friendly fiscal policy and structural reforms that are conducive to growth. This implies for different countries different things.

In Spain we have done two labour reform, one pension reform, two financial reforms in four years. Do you think that in Germany the environment is the right one to have a change in fiscal policy?

Visco: I am not asking Germans anything. Governors do not ask politicians in other countries to do something. You are talking about Germany, I am talking about Europe. Within the G20 group, there are recommendations by the OECD for Spain, Italy, France and for Germany. I believe that these recommendations for Germany have to do with the service sector. Manufacturing is fine, it is first class, but there are recommendations for the service sector and infrastructure. It is to be left to them, but these are issues to be discussed frankly.

The Bank of Italy has been critical of the bail in mechanism. Why has the Italian proposal of a transitional period not been accepted in Europe?

Visco: Our proposal was more than a transitional period. We had many discussions in 2013 and 2014, after very serious banking problems related to some sectors in Spain and Ireland. Such problems were costly and were paid for with public money, including our public money. In other countries these problems were related to so-called legacy or toxic assets, financial structured products gone bad after the global financial crisis: these were paid for by governments in Netherlands and Germany. There were also problems with shipping loans. These were all dealt with public money. At the end it was clear that those who put the public money thought this was a risk from the point of view of moral hazard. In the case of Italy, we had a different kind of problem: a prolonged and deep macroeconomic recession, which has affected the industrial sector. The industrial sector in Italy is financed by banks and is made by enterprises that had not adjusted or fully adjusted to the changes brought in by globalization and technological change. After the financial crises, these companies had problems to recover, and the recovery was predicated on the recession being somehow over in one or two years. Instead, it was prolonged. Many say that there should have been government intervention, such as creating a bad bank before 2013. The only public money was put into Monte dei Paschi di Siena, but MPS had a particular story of malfeasance that we are still dealing with. But until 2013, the system had capital ratios which were above the regulatory limit, with the exception of some

small banks that we regularly deal with. There was an increase in NPLs, but this started to become very serious when the second dip of the recession took place, that is in 2013 and 2014. This is exactly when the rules of the game were changed. In the discussions with our partners, which took place at a political level, not at a supervisory level, we made clear two things: first, that even if there might have been a decision on not using any more public money for a large part of specific banking problems, we still had to take care of systemic risks. These things should never be forgotten: there is a need for backstops, at public level, in Europe, not just in Italy, as it has been used elsewhere in the world, when there are critical systemic situations. Even if it was recommended in the so-called "Four Presidents Report", this backstop has not been put in place. Secondly, we said that even if you do not want to intervene in banks, this has to be clear and focused: in order to be clear, you need sufficient time, in order to be focused, you need to use instruments that are contractually explicit and targeted for that. The decision instead was to use what was on the liability side of the banks, in an order starting with a particular kind of debt which in some countries was also sold to retail customers; it had clearly a risk attached, but only in case of liquidation. This risk of liquidation was transformed in a risk of resolution, even though these are different processes. This goes beyond what we have seen afterwards, ie that in a certain number of cases these products were sold inadvertently or without following the necessary transparency conditions that were set up by the European and Italian laws. Why did we not succeed in the negotiations on bail-in? Most of the interest put forward in the discussion was not to repeat, on the part of the countries that had already paid the cost, the same experience of using taxpayers money to solve bank problems. Italy was the main country not to have faced it, because of the origin of the problems, and has suffered for that. There were also political issues: Italy had continued political changes, which complicated things.

Do you think that there is a major risk for the banks in Europe? Do you think Europe is prepared to face such a risk if it comes?

Visco: Europe needs to complete the banking union seriously. To complete the banking union seriously means continuing supervision, and in supervision we have an established system which is a clear, well-defined system where we know the rules of the game. The banking union has been created in one year, the monetary union has taken eight years. The single supervisory mechanism deals with systems that are different: some have few big banks, others have many very small banks and a few large banks. There are systems where banks are mostly commercials, others where they are investment banks. Banks may fail, have problems, and we had different ways to solve these problems. We now have a single way, in principle, to resolve the banks, which comes after the BRRD. This is in the hands of a single resolution authority, but we do not have a common backstop, as it was initially foreseen for the single resolution fund, and we have limited resources for the resolution fund, that will grow slowly over time. The question is when will it be usable, if not used? The third pillar, moreover, is completely missing: we are now saying that we need to reduce risks before thinking of sharing them. But this was not in the conditions of the banking union to start with and may lead, paradoxically, to a point where there is nothing left to share because all the risk has been reduced. The reason why it is crucial to share common resources is not to put the money there, but not to put the money there, since everyone knows that there is potentially enough money and, as a consequence, there is no self-fulfilling crisis. My short answer is that more has to be done, the sooner the better and with flexibility. This flexibility has been underlined also by the last IMF's Global financial stability report.

When you talk about the backstop, do you mean just a European backstop or also a national one?

Visco: Both. I think the European backstop should be there, the national backstop is an issue of State aid and what is State aid. Here we have frankly a debate.

Is there an agreement on what exceptions can be made to the bail in regime? Margrethe Vestager, EU competition commissioner, has said in an interview that bail in should always be applied before having State aid, while others believe there can be exceptions in the case of systemic banks. What do you think?

Visco: There is something called public "precautionary intervention", so it exists. It is a matter of recognizing and interpreting it. The big problem with this issue is the use of it, who decides when you can use public money to intervene in a banking crisis: at what level, how large the risk, how systemic the risk. In the case of four small banks, covering 1 per cent of total assets, in principle it should not be a matter of concern, but actually it is a matter of concern. People ask where was the Bank of Italy when these problems emerged: we were there, day by day and minute by minute, instance by instance, talking with the government on a daily

basis. The public opinion and the media do not really know the issue. The relevant thing is that I am more concerned about big instances: financial crises can never be ruled out, we can reduce the risk and counter it, but there is always one, it is part of the fact that we live in a capitalist world and banks are private enterprises, we cannot replace them in taking decisions. We should have the powers to face in the eyes those who are responsible for taking decisions and decide whether they are fit or not, something that is only very recently in our powers. It was not until a few months ago. Certainly, if you face a big risk, you need the possibility of intervening. How is it going to be established? Who is going to check? This is very important. That is why I say there is no backstop. This discussion has not taken place, it has to take place. The other thing that is important in this discussion, is understanding what is State aid. It seems to me the interpretation is that there should not be State aid, full stop. When I studied in the 1960s, I have learnt different lessons: if there is a negative externality, there is a case for a public good to be delivered and for an intervention by the State, to correct the market failure or to counter the externality. My interpretation is that, at least for Italy, there has been a major negative externality which has not been caused by ill-behaviour of specific banks. Some banks have added to that by their behavior, but it was caused by a prolonged and deep recession, which is a macroeconomic factor and in the end it was visible in banks' balance sheets. In the years of the crisis Italy's gross domestic product fell by 10%, industrial production fell by 25%: the Italian banking system has not collapsed. Any other system – not as well taken care of - would have collapsed. As for public intervention: to counter the negative externality, the answer should have been to put some money in a special management company, an asset management company with the direction and some support from the State, to deal with the effects of this macro shock. I think this is justified State aid. I agree it is State aid, but I think it is justified. So this is my position in the debate on State aid, but is a position of a person who has studied in the 1960s and not in the 1990s.

The Italian economist Luigi Zingales suggested a few weeks ago that Italy should apply for a programme from the European Stability Mechanism, just like Spain did in 2012. Back then, in Spain the authorities were saying that the banks were solid, just like the Italian government did this week. Don't you think Italy needs a systemic solution to the NPL problem?

Visco: I wrote about a systemic solution three years ago. I think that we did not get it. The reason we need one is not that the banks were not robust, but because they were undermined by the recession. The return on equity is positive, but is too low, it does not pay back investors. Therefore, the market penalizes them and next time you need capital, you cannot raise it, because the return is not high enough. Unlike Spain or Ireland, this is not because there has been a real estate bubble. Unlike other banks, there is no concentration in shipping. Here it is a widespread effect on small, medium-sized and large enterprises. With the benefit of hindsight, the banks were probably wrong in giving these loans, but they were doing so on the basis of macro forecasts – that all of us had in mind – that were predicting a recovery rather than a second dip. My impression is that since a systemic solution has not been possible, we are putting a number of different measures together to deal with this in different ways: you may call it imaginative, you may call it self-defence by the private sector, but we introduced a series of measures. Firstly, we do not have a NPL market in Italy, so the public guarantee scheme negotiated by the government (so called GACS), provided there is a private initiative, helps kick starting the market. The legal impediments to allow a more rapid recollection of guarantees and collateral, which used to take many years in this country because of the absence of extra-judiciary procedures, inefficiencies, and a system which used to excessively guarantee the defendants, has been changed dramatically with laws both mid-last year and more recently. Third, the decision by the private sector to set-up a private alternative investment fund, stimulated by the government and by us. We did not force the banks, and the fact that they were not forced can be seen in the size of the fund, which is sizeable but not as sizeable as it could be and would be nice to have. This fund was decided when the banks understood there were systemic risks they could face if they did not put their acts together. This is working. It was established to intervene in rights issues if capital markets were not able to provide the capital that the supervisory authorities had asked some banks to raise and to favour a better pricing of NPLs. We are already seeing a substantial reduction in the prices of NPLs, even if at the moment this is based on anecdotal evidence.

Could you please explain what is Atlante?

Visco: Atlante is an alternative investment fund, put together with the participation of many financial institutions, mostly Italians. It amounts for the time being to slightly more than 4bn euros and it has been put together by financial institutions and Cassa Depositi e Prestiti, which belongs to the Treasury but has a limited share of the fund. Atlante is managed by an asset management company, which is managing it independently from the banks, otherwise us supervisors would have not considered the company sufficiently

separate from banks. This fund will intervene putting resources where capital has to be raised by some banks and the market has problems in providing it. These first six months of the year have been very difficult, not only for Italy: there has been the emerging markets crisis, China, geopolitical risks, the risk of Brexit. These banks are undertaking restructuring plans, but it is very difficult to raise capital in these conditions, as there is plenty of uncertainty. Atlante is intervening because if it had not, and capital had not been raised, these banks, even if small, could have created financial instability, since there was no public money that could be provided. This instability could have affected every bank, by increasing the cost of funding for all of them or reducing the value of assets in which all of them invest, including insurance companies. This is one part of the tasks. The other part is using resources not invested in banks' capital to purchase the risky tranches of bad debts securitizations. If there was nobody that would go in this business, there would be only specialized investors in this market. These are efficient investors, but they offer very low prices; as a consequence, they would make more money, but the transactions would have less effects on the balance sheets of banks. Atlante is not a public bad bank, but it performs a similar role through an asset management company put together by the private sector, even though the resources to invest in NPLs are not that high. So you need other investment funds or other contributions to this fund, or you need this fund to perform well. If Atlante performs well, the prices of the NPLs sold in the market will certainly go up. I think it was a good idea, it has to be followed carefully from a supervisory point of view and we are doing this with the ECB. It has to be clear that the objective of the fund is a collective interest and not an individual interest. This is very important, since the collective interest implies minimizing the effect on the overall cost of funding and the spillovers between paper in this country and paper abroad.

Despite this measure, don't you think that the Italian banking system is more vulnerable to shocks than any other financial system in Europe?

Visco: No. I don't think that is a good reading. I think there is a problem in using the word "system". There are many different banks. Today there was a report in Borsen-Zeitung emphasizing how many good banks there are in Italy. There are, however, identified cases, that show the risks that when you do not approach the resolution of a banking crisis in a proper way, you may increase contagion rather than reducing instability. The case of the four small banks was clearly a problem, they were approached using all the BRRD measures. We did not deviate at all from that. We dealt with them at the right time, in the right way, with all the criticisms that were made because we used it. Once you have a law, you apply the law. The Bank of Italy will always apply the law. We may say that you need to approach things differently, we may spell out how to do this, but obviously if there is a law there is a law. This shows that in general there is a problem with this approach. In Italy, for example, we have Monte dei Paschi: it is a problematic bank on which we have taken actions from a long time ago. The French had Credit Lyonnais, then there is Dexia; in Germany there were also a couple of problematic banks. There are always problematic banks, but these are specific problems. We now have a specific problem with these two banks in Veneto (Banca Popolare di Vicenza and Veneto Banca), which are being supported by Atlante. We also have one problematic bank based in Genoa (Carige). Behind each one of these problems, there are interventions by the supervisory authorities, both European and national. We may discuss whether the process to approach these things is too long, whether the distribution of powers between the administrative and the judiciary authorities can be changed, whether they could work more closely together, but at the end we did all that had to be done appropriately. If you read at times that others think differently, it is either because it is not well-known what the actual powers of the supervisory authorities are and how they proceed, or because there are political interests. We are very independent.

The Italian and the French government have asked to the Single Resolution Board not to go too hard with its capital demands. What is your view? Do you think the European authorities are asking for too much capital?

Visco: There was a need to raise capital because capital ratios were low because of the crisis. We understood they had to be increased. Capital ratios are the capital you have over assets weighted for risks: if the game in town is to reduce the weights, then you easily increase the capital ratios without actually increasing the amount of capital. The strength of the regulatory process was to change that game and I think we succeeded. Take this banking system: we moved from average capital ratios of around 7% to more than 12% in few years, and similar increases have taken place everywhere. Capital bases have increased in size and quality. The capital that we have now, then, is of better quality, apart from being higher. We took a large number of other decisions. Think about the buffers above minimum requirements, the additional requests as a result of stress tests and the decisions about Pillar 2. All this implies that we have to check for potential unintended consequences, which is perhaps whether we regulated and requested too much, but mostly

whether we left the European system – made of many different components – with too many uncertainties. The most important thing now is to make clear that we are done. This is, for instance, the decision that the Governors and Heads of supervision (so called GHoS) took in January at the global level, when they said first that there is not going to be a “Basel IV” and second that capital in the global financial industry will not increase. There was a word added, “significantly”, but “significantly” implies that there are certain banks that need to have some additional capital to face the risks that are identified. Yes, it is a system whose regulation we have to carefully assess, but especially a system which needs to have certainty about all the rules it has to satisfy, including, by the way, leverage ratios, liquidity ratios and any new additions that are being put to make it more resilient.

The chair of the Eurogroup is accusing the European Commission to be too indulgent about the economic performance of some countries, for example France. He adds that this is creating future imbalances and that the Commission should be harsher. What is your impression?

Visco: A central bank is in favour of two things: price stability and, of course, orderly conditions on the government budget. The problem is that when one says that there is excessive flexibility, first of all one should remember that flexibility is part of the game, so we are discussing about the word “excessive”, not “flexibility” per se. Rules are there to be respected, but they were designed to meet exceptional circumstances and not to discourage the implementation of structural reforms. Given this set up, one can discuss what is “excessive”. I am not prepared myself to say anything about whether France is violating the flexibility embedded in the rules, but I think that this issue has to be considered with care. There are two problems. First, there is a technical point: in order to understand the fiscal position of a country, you need to measure things like the potential output and the cyclical position of the country, because we now talk in terms of structural deficits. In Maastricht, we used to talk about simple deficit measures: it was easier, well-defined. We have complicated things by adjusting for the cycle. Now we have a very slow recovery: is it because we are still at the beginning of the cycle, or because potential growth is now lower? It is difficult to say. These are very complicated things; they need expertise, of which we have plenty, and common sense, which is something not very much in use these days. The second point is deeper: we live in a world where we have one central bank, a single currency, and a large number of fiscal policies. It cannot go that way. This is really deeply wrong. We need a common fiscal policy, to deal with different cyclical positions of our area versus other areas in the world and of different countries within the euro area. This is how we should counter the different effects of the cycle, or a common threat: I am thinking very openly about migration. If you need to deal with migration, you need a common tool that needs to be put against that common problem. This has not to do with flexibility, it has to do with the need for a common response of the area. I went further in this in my speech at the end of May: I said we need a common facility, which means a budget of sort, but also common instruments, which means a debt which is European debt. Then another question comes: what about the rest that is not within this common debt, but is national? There are a number of proposals to deal with that. We need to discuss them openly. If we keep postponing these discussions we do not do ourselves a favour.

Let’s discuss your concept of a fiscal union. Who would bear the cost of countries trying to get a fiscal free lunch?

Visco: First of all, the issue is not my concept of a fiscal union. If one goes back to the preparatory work for the Maastricht Treaty and, more recently, to the “Four Presidents Report” the fiscal union is there. We need a union which has fiscal policy set by a single entity for all, legitimated by a parliament, a euro-area component of the European parliament, together with national parliaments, and which has the tools to do that. I had a debate with Francois Villeroy de Galhau on his proposal to introduce a Finance Minister for the euro area; my disagreement with Villeroy was that I do not think this could solve the problems if this single minister of finances became a super-commissioner, because we already have a commissioner. He has to be someone who has powers and resources, then we may dispute how these powers and resources are used. As for the free lunch, I don’t think there is a problem of free lunch. There is a proposal from the German Council of Economic Experts that goes in that direction. We may consider it good or bad. There are refinements proposed by many sides, including economists from different European countries. These proposals need to be discussed seriously.

You have talked about the need for common sense in fiscal rules. Do you think that sanctions are common sense, or are they pro-cyclical, that is an economic euphemism for stupid?

Visco: What is stupid is a problem, but at least is understandable. The big problem now is that many aspects of the European framework are not easy to understand for us, the general public and politicians. We have a big debate about fiscal rules forcing countries to be extremely pro-cyclically, cutting debt no matter what. This is not what is written in the rules: the rules are much more elaborate and careful. But obviously if you have two different rules, one on debt and the other on deficit, you may easily find that the two do not necessarily convey the same prescriptions. Moreover, you have to maintain conditions to avoid the fiscal free lunch and moral hazard. We may say that the Germans are fixated with moral hazard, but it is something important, we need to trust each other as Europeans and therefore we need ways to avoid moral hazard. Having a system of sanctions is one way, having the threat of defaults is another. If you think how they organized the political union in the US, they opted for the latter. I am asking for a federal budget, frankly, and then countries have to balance their budgets. If they want to spend more they have to raise revenues. If they think they will be able to have revenues tomorrow, then they can raise some debts, but that debt is not guaranteed at the federal level.

Does that mean you would be in favour of defaults within the eurozone, that is allowing Italy or Portugal to default?

Visco: Not as things stand now, but when you have a political union of course. When you have a political union, you have a single entity with a federal debt. In that case, Italy's debt is like California's debt. So people will be very careful where they put their money.

Which reforms are needed to boost the recovery: raising productivity, lowering labour costs or lowering taxation?

Visco: You have said them all. We need to raise productivity, I have said it for 15 years, maybe more. The big mistake that the Italian business sector did was not to try to reduce its costs by raising productivity, but to reduce it by cutting wages. They used the flexibility that the labour market had, which was not a good form of flexibility. The attempt of recent reforms is to make this flexibility good. Between the mid-90s and the early 2000s the business sector managed to reduce costs dramatically, they hired young people on temporary contracts to replace retired older workers, paying them very little. For some time, this worked and kept them afloat. Then there was the hit of the crisis. It is clear that productivity has to increase, via investment. Labour productivity is not something that comes because workers continuously put in additional effort, but because they work in a context of technological change and capital deepening. You need to improve the skills of the workers, in a world that is very different from what it used to be ten years ago. You also need to understand that the more you tax the factors of production, the less you can obtain in terms of growth. When we say that the tax wedge on labour is high, it is something that implies that when there will be the possibility to reduce it, it has to be reduced. And obviously, I understand there are budget limits and that you cannot do that now. I think we should have a comprehensive assessment of what is needed, that goes from business climate to taxation, the deficiencies of the public sector, corruption, tax evasion, education, public infrastructure. There is a large number of things. You put all of this together to reach a higher growth rate that is sustainable. Obviously you cannot move all these pieces at once, but they have to be there and it must be clear to the rest of the world that you are going to act and you are considering all of them simultaneously. This is hard but it is part of the game.

Have you sent a copy of your book to Jens Weidmann?

Visco: Yes, I have, because he reads Italian.

Jens Weidmann came to Rome to give a lecture. Do you have a message back to him, or, indeed to the French central bank governor?

Visco: I know there are jokes, but if you look at the table where the Governing Council sits, it happens that the three of us are sitting one next to the other, not because these are the three largest countries, but because we are in alphabetical order. We all work for the euro area and being so close we have developed a habit of discussing, talking, interacting when we decide. We are in excellent relations, I really think this has to

be underlined. There are differences of views sometimes, but these different views are not permanent: it is not that one is a dove, one is a hawk, and someone else makes peace. It is a dynamic and profound discussion. Each one of us contributes with his own background, expertise, information. I am pretty satisfied with the way the Governing Council works. I am deeply uneasy when someone says that Frankfurt does monetary policy, because this is a substantial collective effort in which we put a lot of time, resources. We have a lot of analytical work that is used in taking decisions on monetary policy. Even measuring the deflation risks, there is a lot of analytical work we and others do. Do you think that the decision to go negative on interest rates on the deposit facility came out of the blue? No, there was a lot of work done by us among others. I appreciate very much working with them. They are very smart people and they know that they have heavy responsibilities being the governors of important central banks in Europe, and that's the same heavy responsibility that I feel.

Speaking of negative rates, the 10-year bund has just gone negative. What is your reaction?

Visco: We have been discussing unconventional monetary policy for some time. If you have a risk of deflation, you create money in this unconventional way. It is unconventional by today's standards, it was not in the 70s or 80s, when purchasing assets to create money was common practice. Since the 1990s, monetary policy has been done through interest rates and, back when I was studying, the instability associated with only moving the interest rates was very clear. Going negative is very unconventional monetary policy, since we are not used to negative interest rates. The case of Germany is complicated by the threat of Brexit, because they are having a lot of inflows. Say there are inflows from the pound to the euro in German papers, those who are buying bunds are not considering the fact that there are negative interest rates, but that the pound may depreciate substantially vis-à-vis the euro, so it is a temporary thing. The way we approached it was to have a negative interest rate on the deposit that commercial banks have in the central bank and this has the objective to stimulate banks to provide more credit to the economy, because this is the way they can obtain a positive return, rather than a negative return in the central bank. We also adopted a new refinancing facility targeted to the credit they are providing: if they increase lending, then they have a subsidy, a negative interest rate on the funds we give banks. These two things together are really designed towards increasing banks' ability to sustain risks that are difficult to price in a very uncertain environment, and to stimulate demand. I do not think this should go on excessively, I think the normal state is with positive real interest rates but you have to understand that low interest rates are not only the result of monetary policy: in the main advanced countries real long-term interest rates were about 5% in the early 1980s, around 2% before the financial crisis, they are now approximately zero percent. This is not the effect of central banks actions, this is the effect of the productivity slowdown that we have been seeing. This is the question mark for the future, whether the world will be able to grow in the future, getting the benefits of technological change and innovation or not. If it does there will be productivity increase. Obviously the question is how you support those who have difficulties in finding a job. This is the challenge.