Transcript: WSJ Interview With Bank of Italy Governor Ignazio Visco

Official discussed the eurozone economy, Italy's economy and ECB policy

Bank of Italy Governor Ignazio Visco in May. Photo: claudio peri/European Pressphoto Agency
By
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Ignazio Visco, governor of the Bank of Italy, sat down with The Wall Street Journal's Tom Fairless for an interview Friday, Oct. 13, 2017 on the sidelines of the IMF/World Bank meetings in Washington. They discussed the eurozone economy, Italy's economy and ECB policy, among other topics. Here is a transcript of the exchange, lightly edited for length and clarity.

Q: The eurozone economy is strengthening. Do you think it's time to start reducing (the European Central Bank's monthly asset-purchases, a program known as quantitative easing or QE)?

VISCO: The recovery of eurozone economy is firming and broadening, as we are seeing it in many different countries. We are glad that it is finally taking place in Italy. At the same time, underlying inflation is not picking up to where we would like it to be: core inflation is still around 1% in the euro area. There is then a consensus in the [ECB] Governing Council that monetary accommodation still needs to be substantial. This means we are not going to hit the brakes.

Q: What are the risks to the eurozone's economic recovery?

VISCO: The current situation is very different than at the beginning of 2017. Political risks in Europe have declined and we now have a more balanced set of risks. The economic recovery is of course helping. But on the downside, we still observe that financial volatility is very low via-á-vis political and geopolitical uncertainty, which is still high—perhaps more outside Europe than inside. So there may be too much complacency in the market and this is a risk that we are closely monitoring. For the time being, there are not substantial worries, but there is a lot of attention. The risks that we are facing in Europe are related to the management of immigration, to Brexit, to the internal dynamics that are emerging in some countries. These problems may have an impact on investment decisions, but the risks are certainly more balanced than in the past.

Q: How much of a risk is it for Italy's economy if interest rates start to edge up?

VISCO: If interest rates edge up, it means that things are getting better. So this would be a very good result. It would mean both that the euro area economy is recovering and that price growth is in the range that we desire.

The Italian issue is overemphasized, because growth is picking up at a similar rate as in the rest of the euro area. This recovery is the result, which is gradually materializing, of the recent economic reforms. Structural improvements, then, are finally showing. But more has still to be done, because part of this acceleration is also linked to growing world demand.

In Italy, debt in the household sector is very low. Leverage in the corporate sector is going down. The banks, if interest rates increase, will improve their profitability because interest margins will rise, even if, over the past months, they have benefited from capital gains as a result of low rates. The public debt has a long maturity, so the effects of a rise in interest rates will be distributed over time. But what is most important for debt sustainability is the difference between the interest rate and the growth rate. If this differential is kept under control, if there is no sudden loss of confidence and capital movements that would negatively affect the economy, public debt would not be negatively affected. On the other hand, it is clear that we have to keep being prudent on the fiscal policy side,

Q: How effective has QE been as a tool for the ECB?

VISCO: At the beginning of the crisis the views were split in the Governing Council, we have to be honest about that. But if you ask retroactively, I think everyone in the Governing Council would tell you that monetary policy was and continues to be effective. It was effective in eliminating the deflation risk, which is an extremely important development because we live in high-debt economies.

It was effective through a number of channels. We have induced a portfolio rebalancing, which means stimulating investment and reducing the cost of capital. We have effects on household wealth through capital gains. But QE also works in supporting positive expectations and confidence in the economy.

For the period 2017-2019, we estimate that the impact on (gross domestic product) of QE and of the other measures we have adopted is in the order of 0.5 percentage points per year. In Italy it's even a little bit higher. Our measures have contributed decisively to the fall of the deflation risk, but we still have low inflation. The slack in the economy was probably even higher than we thought when we started this program. One reason is that the unemployment rate doesn't tell the whole story about the slack in the labor market. A good indicator can be obtained by comparing the number of hours worked per worker to its potential level; this indicator signals a much larger slack than the simple unemployment rate. In addition, wages tend to respond with a delay to the actual improvements in the economy. These are the reasons why we have not observed a substantial acceleration of prices yet.

Q: What do you think about the (Bank for International Settlements) argument that there are supply-side factors that are holding inflation down, technology or population aging for instance?

VISCO: It is clear there have been supply-side effects, both from globalization and from technological progress. But the supply-side effects have been on the price level, not on inflation. In the past, they may have kept the increase in the price level from being larger than what we observed, but this does not imply they are the reason for the prolonged current period of low inflation. This is an argument that is less valid nowadays, because the global trade-to-GDP ratio has barely risen in the last few years. So I'm skeptical.

Q: ECB officials have recently expressed concerns about the currency, what kind of level would you be concerned about?

VISCO: We do not target the exchange rate, but it is a channel of transmission for our monetary policy. Our unconventional measures—which include not only QE, but also the negative deposit rates and forward guidance—have exerted their effects through a number of channels. Among them, this package has been able to clarify to the markets the differences in economic conditions between the US and Europe. This has brought forward an adjustment in the exchange rate, which has facilitated the rise of inflation. So in this sense, the exchange rate is very important. Even if the recent appreciation is not particularly large, we have to be very careful and monitor these developments.

Q: Is it a good idea to set a concrete date for when the ECB's net bond purchases will end, to give investors clarity?

VISCO: You may be clear—and perhaps more credible—also by telling the markets that you are flexible. And this flexibility has been very important so far. It would be a big mistake to implement monetary measures by looking only at current or the short-term developments in the economy. You must necessarily have a medium-term perspective. And it would be foolish to fix a terminal date in the face of the current risks, which may make the outlook change suddenly. We have to be very clear on this point: our decisions are and will be data dependent. And our decisions will concern the whole package, not only QE, but also the forward guidance and the level of the policy rates.

Q: Would you support a longer extension of QE at a slower pace, as (ECB Chief Economist) Peter Praet has suggested?

VISCO: For what concerns the duration, we said that QE would be extended for as much as necessary—I would stick to this message. In the future, we may reduce the pace and one day we will also taper the purchases, but this would not mean that we will abandon QE. It is important to clarify this point since now: there is a flow effect and a stock effect of QE. The flow effect is related to our constant presence in the market, which receives substantial attention from financial investors. But the stock effect is also sizeable and the reinvestment of the stock is another important part of this package. We have to understand that we are not in normal conditions, we are only gradually returning to normal conditions and our package of policy measures is there to help this process.

Q: How much scope is there to expand QE again given the self-imposed constraints on the program?

VISCO: We have not discussed this question. We took a very important decision of buying government bonds yielding less than the deposit facility rate and reducing the maturity below two years. These two measures have already represented a substantial change, so there is no real worry. But if there are decisions to be taken, you can trust that we will take them.

Q: When might interest rates start to increase? The ECB's current wording says "well past" the end of its net asset purchases.

VISCO: The first thing we have to ask is the reason why interest rates are so low. It's not because the central bank sets them low. There are fundamental forces which contribute to determine them, such as demographics, technology, the legacy of the crisis, the low inflation rate environment and so on. The ECB has certainly maintained easy monetary conditions, but this is has not interfered with what the real economy is currently producing, which is a low real interest rate. However, if real rates start increasing, obviously this will have consequences for our monetary stance. We then have to analyze where the real rates are and how and why they are moving.

This means that not only the timing and the composition of QE is data dependent, but also our "well past" is data dependent. If we start observing that the path of inflation is going in the direction that is consistent with our price stability target, if the economy is firming and we are coming back toward higher potential growth rates, this certainly would be the time for moving interest rates. It is important to say that "well past" means "as things will change". You cannot determine ex ante when rates will rise.

This said, my view is that the most unconventional component of our monetary policy is the negative interest rates. Note, however, that if interest rates will be increased, this doesn't mean that there will be high interest rates and that we will fall into a phase of restrictive monetary policy. It means simply that we will be adjusting to the new economic conditions that are getting back to normal.

Q: Does that mean the ECB could raise interest rates to zero and then stop?

VISCO: It is hard to say that now, because it really depends on the data. But we are well aware of the potential harmful side effects of negative rates. So far, we have not observed harmful effects, because the profitability of banks has risen thanks to the improvements in the economy, but we have to monitor these developments on a continuous basis.

Q: Another side effect of very low rates is the survival of zombie firms. Is that something that could be helped by higher rates?

VISCO: We undertook a lot of research in our country with the (nonperforming loans), an issue that is oversold by the press, and we clearly have to be careful with how this question is appreciated by the markets. The figures are most of the time way off the real numbers. But we are worried that a substantial number of firms that were affected by the crisis could lead to adverse economic zombie effects of substantial importance. The risk is there, but it has not materialized so far and unprofitable firms have indeed shut down. One first key risk is that the presence of zombie firms makes lending to better firms less easy. We had a fall in the demand for credit, but we didn't have a credit crunch because there were too many zombies around. A second important effect is that the presence of zombie firms hampers competition. Our research suggests these two effects, so far, have been quite negligible.

Q: Do you see any evidence of risk of asset price bubbles?

VISCO: We monitor continuously the real-estate market, corporate bonds and equities. So far, there is no such evidence. Obviously, it might become a problem in the future. In that case, we will have to looking first at the possible macroprudential responses, which means that we have intervene with specific measures where we see a potential bubble.

Q: What is the current state of Italy's banking sector, have problems been largely resolved?

VISCO: Some banks had specific problems that were aggravated by the crisis. The two Veneto banks, for example, attempted a capital increase that was badly engineered and the market was not responding. But what I first want to stress is that the way we solved the problems were totally consistency with the European legislation and that we supported the government with our advice.

About the current situation, my impression is that most of the tail risk has been taken care of. We are in a path of reducing nonperforming loans, which have fallen from a peak of almost 11% at the end of 2015, net of provisions on banks' balance sheets, to 8.4% at the end of June 2017: the reduction is then quite substantial. With the NPL sales of Unicredit and (Italian bank Monte dei Paschi die Siena), the ratio will fall to less than 8% by early next year.

We have also seen improvements in the way banks are organizing NPL restructuring. From a legislative point of view, there is an improvement in the speed with which the judiciary comes to the final decisions in the various stages of the process. Again, however, Italy can and should do more.

The problems that remain are the structural issues for the banking sector, which we know well: they concern moving towards a path of higher profitability, tackling the changes in regulation that are being finalized, dealing with financial services that are provided in the market, facing competition from fintech companies and, more in general, from the digital revolution. But it seems to me these risks are well understood by the banking sector.

Q: Do you think the ECB's proposals on NPLs are helpful?

VISCO: I am in favor of the calendar approach, but the devil is in the details. This means that the design and the implementation of the changes is crucial. We will see what comes up from the consultations and then draw the necessary consequences.

Q: In general do you think the Italian economy is ready for less stimulus from the ECB?

VISCO: During the crisis, the measures of the ECB were intended mostly to reduce the financial fragmentation that had impaired the transmission of monetary policy measures and, then, to eliminate what has been the most serious risk that we have faced, which was not a default risk of specific countries, but was the re-denomination risk. The entire monetary union was in danger due to this risk. The ECB has been very successful in removing these risks. This has been very helpful, but fin order to achieve high and stable growth, to obtain further improvements in the labor-market and be more competitive, the actions that are needed go well beyond the realm of monetary policy. I trust that we will take them.