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Governator Visco interviewed by the German Handelsblatt online
Italy's central bank chief warns of the effects of negative interest rates
by **Regina Krieger** and **Frank Wiebe**

Mr. Visco, in Germany a lot of people think that interest rates have to be so low just for the sake of Italy's high sovereign debt. What do you tell them?

Nobody in the Governing council of the ECB works for the benefit of one single country. What we have done is the consequence of the deterioration of the macro economic conditions of the whole euro area. Italian debt – or the debt of any other country − was never an issue in our discussions.

But the ECB had to intervene to help countries in crisis situations.

We do not intervene to help individual countries. When we provided liquidity in the financial crisis, it was to the benefit of all, including German banks, which had many problems and needed the help of the government – help which was not needed at the time by Italian banks. Back then, there was also the risk of the Eurozone falling apart and that certainly was a risk for the whole area, with costs affecting both countries facing a potential depreciation of the currency replacing the euro − such as Italy, Spain and Portugal − but also those facing a potential appreciation.

Obviously the high sovereign debt in Italy is still a problem.

Net of interest payment Italy's public expenditure is in line with the average of the euro area and so is social welfare spending. Interest payments instead, at 3.7 per cent of GDP last year, are about twice the euro area average, reflecting our high legacy debt. And the debt-to-GDP ratio has grown from 100 percent to over 130 percent of the GDP since 2008 not because of high deficits – which have been below 3 per cent of GDP since 2012 − but because of low growth. Growth has averaged -0.2 per cent per year between 2007 and 2018. It is then crucial to raise potential and effective growth.

What can Italy do?

In the short term we have to maintain the confidence of investors, so that the spread of our government bonds can shrink. This has already happened to some degree, but not enough. And we have to have a bit higher primary surplus, meaning the budget surplus before interest payment, than other countries in Europe.

How high is the primary surplus and where should it be?

It has been around 1.5 per cent of GDP in the past five years and, according to government plans, it should hover around that value over 2021-22. This should really be the lower bound. A higher surplus would speed up the reduction of the debt-to-GDP ratio. We are walking a thin line between the needs to be fiscally prudent and to support economic activity. We have to work on structural reforms to become more productive and be able to grow again.

After the ECB decided in September to lower interest rates even more and return to net asset purchases, some people from the governing council like Bundesbank-President Jens Weidmann went public with critical remarks.

There is discussion whether there was a need to take these steps. I think it was a necessary step and this view is shared by the majority of the council. Cyclical conditions are not favourable. The risk of deflation, of falling prices, is still there. I’m worried about the risk of de-anchoring inflation expectations.

A group of former central bankers, including ex-ECB Chief economist Otmar Issing, published a statement and said that there was never a risk of deflation.

I don't share this view. In the past we had a period with prices falling in several countries and in the euro area as a whole and inflation expectation starting to de-anchor. There was a material risk of real debt rising due to deflation. The risk was there for public and private debt alike: not only high public debt as in Italy, but also very high private debt as e.g. in the Netherlands.

Do you think the rift in the ECB council, where there seem to be very different position, can be healed?

We never fight, we have discussions. At the Council I sit between Jens Weidmann and the French governor François Villeroy de Galhau – we always talk to each other. There are different opinions in the council. Some of us think interest rates could go further down. Others think this can only be done if we make sure that there are no negative repercussions on banks’ ability to grant loans and, in turn, on the transmission of monetary policy. Some think we should just print money and change it for assets.

It's no secret that Weidman opposes first of all asset purchases and is a bit more easy with negative interest rates. What do you think?

I have a strong opinion on this. I'm more in favour of asset purchases compared to negative rates. The impact of negative interest rates is small and with potential negative side effects on the financial system. The impact of asset purchases is larger and more widespread.

So negative rates don't help?

They worked fairly well up to now. But the longer they remain negative and the lower they go, the higher is the likelihood of significant negative side effects. I'm not encouraging this.

How low can interest rates go before they do more harm than good?

Nobody knows the answer. Some people think we are already there. I think the benefits may not be worth the costs. Let me stress that interest rates are low because demand is weak and not because of monetary policy. The ECB can only provide favourable financial conditions. We do not affect demand directly. We need more public investment in infrastructure and a better climate for business investment. Negative rates and the longer term loans for banks (TLTROs) were designed to encourage banks to provide more funds for investments. Has it worked? Not much.

Has it worked in Italy?

In Italy it has worked bit more than in other countries. Here the combination of low interest rates and efforts to bring down the amount of non performing loans (NPLs) helped to improve the quality of credit. Banks are being selective: loans are growing to companies with good ratings, not to the so-called zombie firms.

Are NPLs still a problem?

The share of NPLs on total loans was lowered dramatically. Net of provisions, the NPL ratio went down from 10 percent in 2015 to 4 percent right now. In terms of the flow of new NPLs, we are back to where we had been before the financial crisis. The management of NPLs has improved in the banks as have recovery procedures in courts.

Including improvements in the justice system?

Yes. We have evidence that the reforms introduced in the recent past are improving the functioning of the system; for instance the time needed to sell the assets in foreclosure procedures has been reduced by 40 per cent. But there is still a lot to do. In Germany a defaulted loan can be resolved in one year. In Italy it still takes five years. We still have issues, but other countries have issues, too.

Are you talking about the complicated balance sheet of Deutsche Bank?

My view is that the risk of NPLs in Italy and the risk coming from other opaque and illiquid assets elsewhere have to be assessed with a comparable attention.

What do you think about the proposal of the German minister of finance Olaf Scholz to go forward in setting up a common deposit insurance in Europe?

It's good that Minister Scholz starts this discussion again which I think is very important. It is a recognition, that the banking union has to be completed. The way he phrases this completion when it comes to his definition of a European deposit insurance system (EDIS) has to be considered with care. This is not my definition of a proper insurance mechanism, which must envisage a fully fledged risk sharing with the same protection for all depositors in all banks. This may be seen as a final target, but this target has to be very clear. Liquidity lines can only be seen as element of a transition to this objective.

What about a reinsurance solution?

It’s only half a solution because the responsibility remains with the countries. If we want a union, we need a union concept. Sharing of risk and reduction of risk have to go together.

What do you think about the German demand to put risk weights of sovereign bonds in bank balance sheets in order to cut the nexus between governments and banks?

In Italy banks have acted as stabilizers at times of tensions in financial markets and I’m worried that this function could be eliminated by risk measures attached to sovereign bonds, without any alternative mechanism replacing it. The sovereign bank nexus is not abolished by removing sovereigns from banks but by reducing sovereign risk. In the Euro-crisis Italian banks bought government bonds, in the last four years they have reduced them by 15 percent. In bad times they buy more of it, they are a kind of contrarian investor.

Can you explain that in detail?

In Italy households have the lowest risk, they don't have a lot of debt. Then there is the government, which is less risky than companies. Therefore in bad times it's more convenient for banks to buy more government bonds. And let me remind you: when the financial crisis erupted, Italian banks had no investment in opaque assets like in Germany. They were barely touched by the financial crisis.

There is also the proposal to put a limit on how much debt of one government a bank may take.

Again, this would reduce the stabilizers in our financial system. It can only be considered if we have some compensating measure. What we need is a common safe asset issued by a single entity that receives automatically revenues from the member states. That could also be the basis to build a common fiscal capacity for the Eurozone.

How big should this be?

If you look to a federation like the United States or Canada you see primary direct federal spending somewhere around 15 percent of GDP. The euro area is not a federation and can of course start from much lower levels, enough to contribute to stabilize the economy.

There has also been a proposal to create artificial safe bonds.

I don't believe this is a solution. You would have tranches with high risk and low risk – but who wants to buy the high risk?

Do you think Europe is at risk to experience another bank crisis?

Crises can always occur. The question is whether we can solve them.

Can we?

We have only a resolution mechanism for big banks. The US has a deposit insurance, the FDIC, that can wind down in an orderly fashion any failed bank. We are far from this. Moreover, the responsibility of managing a bank failure is split among too many institutions.

And what about the possibility of new bank crisis in Italy?

In Europe we don't have enough instruments to deal with crises of less significant banks. If you don't have that you risk to go into liquidation. And we have a law that says that there is no way that State aid can be allowed to avoid risks of moral hazard. There are banks in Italy which have difficulties, but this is the case also in other countries.

What is your vision for Europe and the Eurozone?

I think there are long-term trends in technology, labour market, environmental issues and demography that should be dealt with together and not on a single country level. It's not only climate change, which is obviously for the government to deal with, not for central banks. Europe is on digitalization far behind the US and China, and Italy is even farther away. My worry is that these long-term trends are more or less ignored.

What is the most urgent challenge?

Our populations are getting older. By 2045 the EU will have 30 million less people in the workforce, with Italy six million less.

What can be done?

There are several political areas. We need higher participation in the workforce, better education and a real immigration policy for Europe. We have an immigration policy in Germany, but it's not linked to the European level. We even have an immigration policy in Japan, they broke a taboo. I'm not talking about refugees here, about the humanitarian aspect, which is also important, of course. I'm talking about people who just come for normal work. But they have to receive an adequate education.

Speaking about demography - does Italy need a reform of the pension system?

We already had a reform, which put our system on a very sound footing, at the highest standards in international comparison. We have linked the retirement age to life expectancy. The previous government has introduced temporary exceptions to the provisions in the reform, but this will be only for three years.

From the populist government you have experienced attacks on the independency of Banca d'Italia. They even wanted to take away the gold of the central bank.

Central banks are natural scapegoats. We have the responsibility to be accountable, to explain, but in hearings, not in talk shows on tv.
It is not important who owns the gold. By law the Central Bank is the owner and in any case it cannot be used to cover the debt of Italy.

What is your impression of the new government?

It is not for me to say. In general terms stability reduces uncertainty and you can see this in the spread. Less uncertainty is good for the business climate and the production. Political uncertainty is still there, not only at the national level but also at the European and the global level.

Do you think politicians and the general public in Italy understand the long term problems of your country?

I'm not sure that there is a general understanding of the benefit of acting on the supply side. Most think it's important to strengthen the demand side. But it's important what kind of demand you have – e.g. from investment or through subsidies. I think the general public doesn't understand this. And politicians may go one way or the other as short vision and political cycles often dominate.

Why is it so hard for politicians in Italy to look out farther in the future?

This is not only an Italian problem. But we had seven governments in the eight years I have been Governor of the Bank of Italy. This doesn't give politicians a long-term prospective. In Germany, in the same period, you always had the same Chancellor.