

Interview given by the Governor to the German newspaper *Welt am Sonntag* on 11 January 2015

Ignazio Visco, who succeeded Mario Draghi as Governor of the Bank of Italy, warns that the risk of deflation in Europe should not be underestimated. He thinks that large purchases of government securities are the most effective countermeasure against falling prices

by Tobias Bayer and Sebastian Jost, Rome

Welt am Sonntag: *By chance, in the meetings of the Governing Council of the ECB you sit next to the President of the Bundesbank Weidmann. After the very controversial debates of recent months how much harmony remains between you?*

Ignazio Visco: Your idea is not correct : in actual fact we are on excellent terms, even if, obviously, we are not always of the same opinion. Do you know why we sit next to each other? Because the seating is arranged in alphabetical order. This means that in the Governing Council we do not represent our countries but we all have a common task - to guarantee price stability across the euro area.

Welt am Sonntag: *In Germany we often discuss which country is the biggest problem today for the Monetary Union: Greece, France or perhaps Italy. Don't you think instead that the real problem may perhaps be Germany, given that the ECB could intervene more if Germany did not put up such strong resistance?*

Ignazio Visco: I wouldn't say that any one country is a problem. Nor can we say there is a conflict between Germany and the rest of Europe. We have a common problem - at the moment inflation rates are very low everywhere.

Welt am Sonntag: *Most Germans are worried less about low inflation rates and more about the measures that the ECB might take to raise them.*

Ignazio Visco: I can only say that the macroeconomic risk should not be underestimated. If inflation rates remain very low for too long and the economy is virtually not growing any more, we risk slipping into a self-sustaining downward spiral – and this is called deflation.

Welt am Sonntag: *Deflation is considered to be dangerous mainly because consumers expect prices to continue falling and don't spend any more, so the economic crisis continues to worsen. Are we already at this point, given that in December prices in the euro area fell for the first time in five years?*

Ignazio Visco: This is just one figure that, nevertheless, comes at the end of a long series of very low inflation rates. This is why the situation is so critical. Consumer behaviour could increasingly adapt to the very low or even negative inflation rates.

Welt am Sonntag: *Lately, however, prices have fallen mainly for one reason: the fall in oil prices. In the last few months, core inflation has been fairly stable. In the past the Governing Council was not influenced by similar movements in energy prices. Doesn't this principle still apply today?*

Ignazio Visco: In principle you are right: a one-off change in the price level cannot be interpreted as an inflationary or deflationary trend. I have underlined this several times, with my colleagues, when prices have undergone a one-off increase, because of a rise in taxes for instance. But now even core inflation is low: at less than 1 cent it is also clearly below our target rate of slightly below 2 per cent in the medium term. If we do not act, we will not be able to fulfil our mandate. And the longer we remain far off our target, the worse it is. According to the expectations of market participants, we will return to an inflation rate of close to 2 per cent only in 2025.

Welt am Sonntag: *But low oil prices reduce the pressure on the central bank to stimulate the economy. According to the President of the Bundesbank, Weidmann, this economic development is a gift to Europe.*

Ignazio Visco: The low price of oil helps the economy, without a doubt. But on the other hand it also causes prices to fall and this is a problem when inflation rates are close to zero. Inflation expectations risk falling further.

Welt am Sonntag: *So you are in favour of the central bank intervening. Does that necessarily mean purchasing government securities or are there any alternatives?*

Ignazio Visco: In the current situation, purchasing government securities is the most effective measure. Within the Governing Council we are discussing various possibilities, including the purchase of other kinds of securities, corporate bonds for example. But the corporate bond market is not very deep and it is mostly the large groups that obtain funding in this way and they can already find liquidity at very favourable prices.

Welt am Sonntag: *Why are you so optimistic about the effectiveness of purchasing government securities? According to the rosier forecasts, even setting up a programme for one trillion euros the rate of inflation would not increase by more than 0.4 or 0.5 percentage points.*

Ignazio Visco: If we managed to raise inflation by 0.4 per cent I would of course be satisfied: it would be an excellent result. We would be on a path that could bring inflation close to 2 per cent as early as 2016.

Welt am Sonntag: *According to the more pessimistic forecasts, inflation will instead increase only by 0.1 per cent – this is almost negligible.*

Ignazio Visco: Our estimates are closer to 0.4 than 0.1 per cent. I admit, however, that this is difficult to predict. Many only think of the effect on the supply of credit and this will not be very great. But quantitative easing also acts through other channels, for example it lowers the long-

term rates, something which has made a decisive contribution to the success of the Federal Reserve's asset purchase programme.

Welt am Sonntag: *At the start of the American programme, however, rates were considerably higher than those recorded in Europe today.*

Ignazio Visco: They were somewhat higher, it's true, but mainly for one reason: to a certain extent the financial markets have today already included quantitative easing in the current prices of euro-area government bonds. Now we have to intervene, otherwise the rates will immediately start to rise.

Welt am Sonntag: *As regards quantitative easing, a decision has to be taken not only as to 'yes' or 'no', but also about 'how'. There are discussions, for example, on who will be answerable in the case of a country defaulting – the Eurosystem as a whole or only the respective central bank?*

Ignazio Visco: That's a fair question. But if the national central banks were to purchase assets from their own budget, financial fragmentation in the area could start to increase again compared with conditions today. We would do well to maintain the procedures that apply to all our monetary policy interventions: the risks are shared by the Eurosystem as a whole.

Welt am Sonntag: *In your opinion, purchasing government securities is therefore a normal monetary instrument and the central bank should not be too concerned with the side effects?*

Ignazio Visco: Obviously we have to consider the effects, but ultimately we have a clear mandate: price stability. The most important instrument for achieving this under normal circumstances is the interest rate. When the official rates fall to zero, all that remains is to increase the money supply. We have different ways of doing this. We could even stand on the streets and hand out banknotes or, indeed, we can buy government securities. This is a standard instrument of monetary policy, which we call 'unconventional' only because for a long time it was not employed in Europe.

Welt am Sonntag: *However, in this way new risks could be created, for example bubbles in the financial and real assets markets. In Germany, there are fears of the property market overheating.*

Ignazio Visco: In principle this risk exists. Investors are always looking for a good return and if the rates are too low this could tempt them to ignore the risks. This has happened in the past. Now, however, the situation is somewhat different. Financial imbalances are not widespread: they are local and can be contained with targeted measures, such as the introduction of capital buffers or loan-to-value limits on mortgages.

Welt am Sonntag: *The ECB has often criticized governments for being excessively slow in implementing reforms and for insufficient progress in consolidating the public finances. Don't you fear that the politicians will let go as soon as the ECB decides on a programme to purchase government securities?*

Ignazio Visco: This cannot be a decisive factor for us because, basically, it isn't a question of monetary policy.

Welt am Sonntag: *But it does have to do with the effects of your actions.*

Ignazio Visco: What we have to do is to create money and ensure that inflation rates start to rise. Governments will have to do their part. The central banks must not accept too many limits on themselves. In any case structural reforms are essential. Jens Weidmann and I are in complete agreement on one point: monetary policy is certainly a powerful instrument but it cannot increase productivity or improve the economic structures. That is the task of economic policy.

Welt am Sonntag: *Are you satisfied with the structural reforms in Europe and, in particular, in Italy?*

Ignazio Visco: Progress is slow in Europe as a whole and also in Italy. The pension reform passed in 2012 is really exceptional, but it is not enough on its own. A central problem in Italy is the high level of uncertainty, which is dissuading firms from investing. Italy's governments change frequently. With each change there is the danger that previously passed reforms will be modified or will not be implemented. This has to stop. Other problems do not concern only Italy however.

Welt am Sonntag: *What are you referring to in practical terms?*

Ignazio Visco: For too long the euro area has underestimated global change. I am thinking of technological progress, the ageing of the population or access to new markets. Structural reforms are needed to make the economy more flexible. I am thinking of education, a more favourable climate for business, less red tape. We are living in a new economy. Ten years ago we wondered whether a 'new economy' could exist. Today it has become a reality.

Welt am Sonntag: *Do you think that Europe can keep step with this new economy?*

Ignazio Visco: There is one great danger: the contraction of Europe's manufacturing industry. Germany is the most important 'factory' in the world: one in five workers is employed in the sector; in France the figure is one in ten. To compensate for the decline in industrial activity we must find new paths to guarantee jobs. New sectors are emerging. Europe must become more innovative. Who would have thought, ten years ago, that we would be using tablets on the move? Who would have thought that a phone call to the USA would cost nothing thanks to Skype? When I was studying in the United States, 42 years ago, we could only afford to call home once a month.

Welt am Sonntag: *Does Europe's monetary union also need a renewal?*

Ignazio Visco: The euro is a currency without a state. It can remain so for a little while longer, but this cannot be its final destination. The next step must go in the direction of political union.

Welt am Sonntag: *At the moment we are not moving forwards, but rather backwards. In view of the upcoming elections in Athens there is once again speculation about Greece's exit from the euro area. Are you worried?*

Ignazio Visco: The central banks must not intervene in the democratic process. But one thing is certain: the Monetary Union must be strengthened not weakened. Most of our actions call for trust. Naturally, the weaker countries have their own responsibility. But it is also necessary that the more stable countries show some understanding. We have to realize that Europe's strength lies in the fact that we are united.