Peter Praet: Interview in *La Stampa*

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in *La Stampa*, published on 22 December 2013.

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Draghi said recently that for the AQR the sovereign bonds will be treated as neutral, but that they will be considered as a risky asset for the stress test. What could it mean for Italian banks?

"I can't comment on this, as even the parameter have not been decided, yet and the stress test will be a joint exercise with the European Banking Authority (EBA). What I can say is that, in general, banks have to manage their risks. The stress test by definition stresses the entire portfolio of the banks, thus including sovereign debt".

Don't you think that the OMT should also change your perspective, when you judge government bonds detained by banks?

"I would not link the two things. The OMT has obviously had a consequence on the pricing of sovereign bonds, to the extent that it has removed from the spread that certain governments have to pay the compensation for the probability that a "catastrophic risk" scenario may materialise: the probability that they may leave the euro area. Stress tests are never made for dealing with "end-of-the world" scenarios, but with plausible events, as adverse as they can be".

The ECB mentioned the possibility of a conditioned LTRO, "British style", a "funding for lending" LTRO, but what are you exactly thinking of?

"It is clear that when a central bank provides liquidity to the banking sector, it expects the banking sector to transmit the liquidity stimulus, in volume and in prices, to the economy. But on the other hand you cannot really force the banks to lend to the real economy when there is a problem on the demand side, when the perceived risk that banks attach to a loan is simply too high. You also don't want that the liquidity injections lead the banks to take excessive risks elsewhere. Analysts often mention sovereigns, but I am not thinking only about that. I think, as also Draghi said, that putting "conditions" on LTRO is complicated for all these reasons. For me the essential is to analyse if and how risks are properly priced and managed by banks".

How's the situation in the credit market?

"On lending to the real economy, what in particular needs to be addressed is the issue about the lending to small and medium enterprises. Recently, we have some positive signs in the evolution of lending. The contraction of lending to non-financial corporation has been 2.9% in the 12 months to October. This had been falling consistently, but in the most recent period the flows of new loans, while remaining negative, have shown signs of stabilisation compared to the earlier part of the year. You have also to take into account that bank lending is in some cases only part of the total financing of a company. Large firms for example tend to borrow directly on capital markets, issuing corporate bonds, and this market for corporate bonds have been doing very well in terms of prices and new volumes. We also see that, on their asset side, euro area firms have accumulated more than two trillions in liquid assets, largely reflecting precautionary savings and reluctance to invest. As profits have been falling, distribution of income to the shareholders and owners has been cut. Large size corporations are better placed here than the smaller firms, particularly in countries like Italy"

How can we address this problem?

"In contrast to most other countries in the euro area, in Italy, you have a marked dual industrial structure: on the one hand there are many very small firms, and the other hand a rather small number of large and very large firms. This is important because credit supply constraints are particularly severe for the smallest firms, which are the first to suffer when banks contract lending".

But what would you suggest?

"Italy has taken some measures that have improved the situation, like the moratoria, which make credit conditions a bit easier, but you still have long-standing and severe structural issues to solve. You don't escape the big question: it's a structural problem and Italy has to make economic reforms. During the crisis Italy has done a lot in terms of correcting its fiscal weaknesses, but has not done enough in terms of economic reforms. The labour market, still needs more flexibility. Labour market legislation needs to facilitate – not hinder – the capacity of businesses to deploy their labour force in the most efficient manner. More generally, competitiveness and the attractiveness of a country as a foreign direct investment destination depends on the "easiness to do business", on its bureaucratic environment, on its judicial system's capacity to enforce the rule of law, on the country's governance in general. Without good economic governance solidly in place, you cannot expect foreign investment to return to Italy. If you look at the last "Doing business" index of competitiveness, Italy is again extremely badly placed".

So "easiness to do business" comes from labour legislation and, more in general, from laws and bureaucracy. But what else should be changed?

"Also, unit labour costs are too high. This does not mean, of course, that salaries are too high in absolute terms, in fact the take-home pay is low in Italy on average in international comparison. Unit labour costs are high because productivity growth has been too low in Italy. But salaries cannot increase unless productivity increases, and productivity cannot increase unless the overall level of competitiveness of the country improves dramatically. Among the countries where sovereign bonds have been under pressure, Italy is the only one where labour cost competitiveness is not improving relative to the best performers in the euro area. This is a concern, also for growth perspective. You see, Italy is a country with a fantastic human capital, some of the best universities, a lot of creativity and cultural richness. But more worrisome is the difficulty of society to work together, to come to agreed long-term solutions, to redress its governance. It seems to me that this is really the biggest issue".

How is the situation in public finances, in your opinion?

"While still increasing, the public debt level is on a better medium term trajectory thanks to reduced annual fiscal deficits . To keep public debt on a sustainable path, it is essential that the government sticks to its fiscal commitments. This means that fiscal efforts cannot be relaxed. For example: to have a debt/gdp ratio of 100% in 2025, you would need, from 2016 on, a primary surplus of about 4,5% of GDP. It is possible, and other countries have kept their primary balances at those levels in the past, but it requires efforts and commitment. In this respect a major achievement is to have put the Fiscal Compact into the Italian constitution. I would also like to stress that the adoption and implementation of structural reforms leading to a path of higher economic growth would make possible a stronger reduction of debt for a given fiscal effort.''

But austerity has been questioned, also by the IMF: in some countries it even worsened the recession.

"The impact of fiscal consolidation greatly depends on how you do your consolidation, on whether you increase taxes or cut expenditures for example, and on what taxes you increase and what expenditures you cut. In Italy you have had so far a greater focus on taxes than on expenditures. One should also try to avoid penalising labour and enterprises. But taxes on labour can only be reduced if spending is curtailed and put under a very tight control. Now Italy needs to be attentive to and cut expenditures: from that point of view, it seems to me that the appointment of Carlo Cottarelli is good news, it gives the right signal".

Is Italy out of the recession?

"Yes, it seems that also Italy is getting out of the recession. I think it is very important, it shows that efforts are paying off in the end, and that there is hope. In Italy the barometer of business confidence is increasing, there is a very important turnaround in confidence indicators. Societies are a little bit like human beings; you have waves of optimism and pessimism, and confidence is very important for firms to return to investment. The turning point is still very fragile, we are only at the beginning of this. That's why we always say that there are downside risks, especially if structural reforms are stopped. But we see positive momentum building up. Many business firms say: we see the situation improving, reforms are being carried out, but it's still not sufficient to start really investing. They are still in a waiting mood".

Italy's coming out of a crisis that destroyed almost 25% of its industrial production, worse than in many countries of the Eurozone.

"In Italy there has been a strong contraction of productive investments, which is restraining growth potential and income creation. Just to give you an idea, investment in the euro area has fallen by 20% since the beginning of the crisis, while in Italy by almost 30% since the beginning of 2008. We believe that investment will start to recover in 2014. In that recovery phase, the ECB will be very attentive, and if there will be credit supply constraints holding back the recovery momentum, we will be ready to act. Contrary to what happens in a recession, where the demand for credit normally shrinks, in a recovery phase credit demand will pick up; and if credit supply will not follow, that could be a problem for the recovery. We will remain attentive that credit supply constrains will not hinder the investment recovery".

Anti-euro parties are rising. Are you concerned?

"There is a fundamental political question here: do we need more or less Europe? We created an internal market which is working, it was worth creating. But it has become clear that we had too little Europe in crisis management and crisis resolution, to deal in particular with situations where a State is in difficulty. EFSF, ESM and the Banking Union are enormous achievements, in that sense. The new institutional set up is still not complete, but it's going to be completed over time. The crisis became so acute in Europe because we had too little Europe. And now we are addressing some of the major problems we have had to face".

Like with the recent agreement on the SRM.

We welcome the deal reached by EU finance ministers on the single resolution mechanism, in particular as it allows for swift actions in critical situations. We deem this a fundamental step towards the completion of banking union. But the process is not yet complete and it needs to be finalised soon.

In Italy there is an alarming tendency to question the euro. What scenario, if a country exits the euro?

"As the President said at the European Parliament, there is no point in discussing a plan B. Furthermore, now that we have stabilised the euro, this discussion does not reflect the reality that the euro is an irreversible project. But let me say another thing: those dreaming of the world before the euro, tend to forget what it really was, before. You remember the inflation in Italy, the repeated competitive devaluations – which were also a consequence of the loss of competitiveness caused by high inflation – the volatility of the exchange rate, nominal interest rates that were in double-digits, and inflation that was persistently higher than elsewhere and eating up the purchasing power of wages and pensions. In Italy you should think about that. Younger generation maybe don't know that, and older generations tend to forget that. Suppose now you want to take the risk of changing the currency: can you imagine all the contracts you have, denominated in euro and signed by the parties becoming uncertain? All your debts, your contracts, at private and public level becoming uncertain? Who pays what, in what currency, when? You get you into a nightmare of widespread litigation. And even in a scenario where all people who are parties to a contract denominated in euro are allowed to pay back in new liras, can you imagine how costly that would be for the borrower to discharge his or her debt in a new currency which in the meantime has probably devalued dramatically vis-à-vis the euro? Instead, we need trust and stability, in Europe. And, besides, monetary solutions are never the real solutions. You should trust the lessons of history".