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FT interview transcript: Lorenzo Bini Smaghi

Ralph Atkins, Frankfurt bureau chief of the Financial Times, interviewed Lorenzo Bini Smaghi, outgoing European Central Bank executive board member, on Wednesday December 21 in Frankfurt. This is a transcript of the interview.

FT: The ECB has just allocated €489bn in three year liquidity to eurozone banks. Will this save the eurozone?

LBS: To address the causes of the crisis you need to address sovereign risk. This is currently being addressed by several euro area countries which have taken severe measures to reduce their deficits. Of course the impact is gradual – but strong measures have been taken, stronger than in any other place in the world. However, they have been taken at a time when confidence was very weak.

The interest in the long term refinancing operation may be a sign of confidence gradually returning. If this is right, interest rate spreads would be pushed down and create profitable opportunities. It would generate a herd movement in a positive direction.

FT: Is it your expectation that banks will use these funds to buy sovereign bonds?

LBS: It is a first step. We have to see whether this will be enough to invert the trend of widening yields spreads, especially at the short end of the curve. For us, this is consistent with our statutory task to implement a single monetary policy.

FT: Are you happy with the way Europe's monetary union has evolved in the past 18 months?

LBS: In the past 18 months, the monetary union has changed in ways which could not have been foreseen. We have a financial safety net – the European Financial Stability Facility (EFSF), to be replaced by the European Stability Mechanism) – reinforced governance and stronger fiscal discipline than at the start. These changes were necessary because the monetary union was built on the naive assumption that there would be no crises.

The changes have not yet helped stabilise financial markets because decisions were often taken too late, under the pressure of the markets and were at times contradictory. Markets were disorientated as a result. One example was the idea of "private sector involvement" in crisis resolution. The position of euro area governments changed 180 degrees within one year, after the disastrous Deauville agreement in October 2010, against which the ECB fought vehemently. Given the damage which was done, it will take time to regain the confidence of the markets.

So there have been lots of ups and downs, but the trend is going in the correct direction.

FT: If governments really wanted to restore confidence they could abandon plans still to have private sector involvement for Greece?

LBS: That would have been more rational, but it would now be difficult to go back to parliaments and change it. I think what governments need to do is, when they agree something, they should implement it rapidly and efficiently and not change their minds a few months later.

FT: How great are the risks of a euro area break-up?

LBS: If policymakers and citizens in the euro area are rational, the risk should be low. The impact of a break-up would be disastrous for everybody – certainly much worse than the pain of implementing measures needed to restore stability. The problem is that often the people and their elected representatives need to see disaster looming before understanding they need to take unpalatable – but necessary – action to avoid disaster.

FT: Do you think it is possible to drive forward European economic integration with 27 culturally different countries, or even 17? What would be the Florentine's approach?

LBS: Some consider Europe's cultural diversity a point of weakness. I consider it instead to be its strength. Having to take decisions together forces you to consider all aspects and views and this helps avoid major mistakes. The major dramas in European history have come precisely from too much uniformity of views within countries. In a crisis it is too easy to create scapegoats, or common enemies – the banking system, for instance. Europe forces countries to work together and find solutions. The cost, of course, is sometimes delays.

FT: Is it not time to think seriously about introducing "eurobonds" to build fiscal solidarity between euro area countries?

LBS: This is a political choice that needs to be taken by the people of Europe. I am not sure it would necessarily be the most efficient solution for euro area public finances. Maintaining the discipline of markets with respect to national budgets may lead to better outcomes than an integrated or federal budget. I am not sure the US Federal budget is in a better shape than the euro area fiscal position.

I could nevertheless envisage a limited amount of joint and several issuance to finance, for instance, specific projects, pan-European infrastructure or a common bank restructuring fund. Such a fund would be needed to support a more centralised system of euro area supervision.

FT: Would you still rule out a default by a euro area country – or a possible exit from the euro area?

LBS: No central bank in the world would consider the default of its sovereign desirable or possible. This should be the same for the ECB, which is the central bank of Germany as well as France, Italy and all the other 17 members. History shows that a default in an advanced country can have a devastating effect on markets and society, including its democratic structure. The same would apply to an exit from the euro area.

FT: Is it right that the IMF should have to help out rich, industrialised countries in the euro area?

LBS: The IMF helped Britain and Italy in the 1970s, which were rich and industrialised. Why shouldn't it help those industrial countries that are in difficulty today?

FT: Is continental Europe best advised to proceed without the UK? Would that allow more progress on financial regulation, for instance?

LBS: We could reverse the question: is the UK best advised to proceed without continental Europe? Continental Europe needs the UK, where the largest financial centre is located and where there is the greatest financial market expertise. The UK financial system needs access to the continent where most of its clients are. There can be no prosperity for either based on beggar-thy-neighbour policies.

FT: What future is there for the City of London as Europe's financial centre?

LBS: The euro has benefited London's financial centre. It is in the interest of the latter that the euro succeeds. The EU, and the ECB, would certainly contribute to help Britain if London was in difficulty. I would thus expect a reciprocal attitude.

FT: Do you think it is right that the UK should have a better rating from the credit agencies than France – or Italy?

LBS: Rating agencies have shown themselves to be pro-cyclical and often pass judgments based on markets' attitudes – thus risking independent assessments based on fundamentals. What strikes me is that countries that over the past few months have undertaken the toughest fiscal adjustment programmes, and thus improved their fundamentals, have run the highest risk of being downgraded, while those that have postponed adjustment, gaining time in particular through easy financing by the central bank, have been considered to be in better shape. It's quite short sighted.

FT: Is it not reasonable for euro area citizens to expect the ECB to act as lender of last resort – to governments as well as banks?

LBS: Central banks act as lender of last resort to the financial system. The concept of lender of last resort to governments is misplaced. Financing governments is not sound and is generally prohibited, not only for the ECB but also for the Fed and Bank of England. Central banks should not purchase government bonds on the primary market. They certainly cannot buy the debt of insolvent governments,

On the other hand, it is the task of the central banks to ensure that markets function properly and price major assets adequately, starting with government bonds which play a key role in the transmission of monetary policy.

Central banks cannot ignore situations where markets are dysfunctional and do not price risk adequately because of inadequate liquidity of certain key assets.

In this respect, the lender of last resort function is typically characterised by constructive ambiguity. Central banks try to avoid committing themselves in advance on the specific conditions in which they will intervene.

FT: Would you rule out more aggressive government bond buying by the ECB if necessary? Or setting limits – like the Swiss National Bank has for the exchange rate – on bond yields or spreads?

LBS: As I said, central banks should use as much constructive ambiguity as possible and avoid committing to act – or not to act – at a time of high uncertainty. But they have to keep in mind their mandate.

The mandate of the ECB is to implement the single monetary policy of the euro area, with the objective of price stability.

The ECB should thus ask itself two questions. First, is price stability being achieved? Second, is a single monetary policy being implemented?

The answer to the first question is yes – just look at the data over the last 12 years and inflation expectations. With respect to the second question, the current spreads along the whole yield curve may raise some doubts about whether we indeed have a single monetary policy in the euro area today and whether the ECB is indeed fulfilling its mandate.

If the issue is not one of solvency [of governments] but rather liquidity, then the ECB has room for action – one could even say that the ECB has a duty of action – to make sure that it indeed implements a single monetary policy.

FT: Why is quantitative easing right for the UK and US but not for the eurozone?

LBS: Central banks are given a clear mandate, to achieve price stability, and the independence to achieve it through the instruments they consider most appropriate.

I do not understand the quasi-religious discussions about quantitative easing. It is appropriate if economic conditions justify it, in particular in countries facing a liquidity trap that may lead to deflation.

The instrument is implemented in the UK and US, where the central banks consider that there are risks of deflation and where the policy rate is constrained by the zero lower bound. This is currently not the case in the euro area because the ECB currently sees no risk of deflation.

But if conditions changed and the need to further increase liquidity emerged, I would see no reason why such an instrument, tailor made for the specific characteristics of the euro area, should not be used.

FT: As an economist, what are the most important things you have learnt during your time at the ECB?

LBS: There are many. But given that more than four out of the six-and-a-half years were characterised by turbulence and crisis, the most important lesson was that ultimately central banks, as policymakers, cannot opt out of their own responsibility for taking decisions. Some of these decisions may not be optimal and may be criticised, especially with the benefit of hindsight. But not deciding, or postponing decisions, is not an option and leads to worse outcomes.

In such times, the risk for policymakers to become "slave of defunct economist", to quote Keynes, is larger than expected and may lead to paralysis. An even bigger risk is to hide behind lawyers to avoid taking action.

FT: Is the world too much in thrall of US economists?

LBS: The world is in the thrall of economists who use too many simplifying assumptions in their reasoning and to make predictions. Real life is more complicated. Policymakers have sometimes to concentrate on second or third best solutions rather than simply assuming that the first best can be achieved. To me, it seems that some economists have become increasingly attracted to quick, simple and shocking answers – just to get the attention of the media and to promote themselves.

FT: Some people think you resigned from the ECB because of pressure from Paris? Is that correct? Why are you leaving early?

LBS: I never faced any pressure, personally. As the ECB president has said on several occasions, ECB executive board members are appointed for eight years and take decisions independently.

For several months there was an unprecedented and unwelcome public debate. Two important principles had to be reaffirmed. First, that the letter and spirit of the [European Union] treaty – which is the basis of the whole European construction – should not be compromised by "unwritten rules". Second, it is in the interests of the EU as a whole and of its individual countries, especially those from which the executive board members originate, that ECB board member members are, and are perceived to be, fully independent.

Once I thought that these principles had been well recognised and understood, I considered that the ECB and the EU should move forward and pave the way for a smooth transition by the end of this year. That was the best way to avoid further polemics and preserve the independence of the ECB.