Good morning, ladies and gentlemen, I am really honored and pleased to chair and open this session today. We will discuss about public debt, banks troubles and real economy, what we have called the "magic triangle". Actually I don't know how magical it is, since we are facing too many difficulties at least in Italy but not only. I think that it is a problem which concerns the entire Eurozone.

I will start with some brief considerations in order to launch the debate on our desk. Let me start by speaking about the Quantitative Easing. Nowadays it is no longer a mystery that the end of the Quantitative Easing could trigger the return of the spread. Last week we had a first tasting of what could happen just with the market reaction to the words of the President Draghi who was just expressing trust in the recovery of the Euroland economy. And markets nervousness has partially plummeted only after Mr. Victor Constancio explained that Draghi's words had been misunderstood. Still on the next Friday, following Bundesbank's President Weidmann statements on the need of ending soon the QE, we saw again some fibrillations in the market. This is only a preview of what could happen if the Euro-bureaucracy does not face properly this issue. So far, both the EU Commission and the European Systemic Risk Board seem to welcome a proposal that envisages the securitization of Eurozone's Govies in exchange for the issuance of European Safe Bonds (ESBies) split in multiple tranches. Actually, I do not believe this would be a solution because it would just "legalize" a Eurozone with at least two or more speeds depending on the number of different tranches of these bonds. In my opinion the key issue with the QE's architecture is the lack of risk sharing among Euro countries. The ECB lends money to the national central banks in order to let them buying domestic Govies. Hence, the risks of the public debt of each member State are borne solely by its NCB which in the case of a sovereign default suffers a loss but remains indebted to the ECB for the entire amount borrowed. This can be seen if you look at the cash flows and at the TARGET2 net balance. And without risk sharing obviously you cannot ask the financial market to bet on convergence. They obviously will bet on divergence and make money with some arbitrage.

In any case, even regardless of the QE-exit conundrum, today Italy is not in a good shape, unfortunately. In real terms the spread is not very far from the levels of the second half of 2011 due to a lingering deflation. But, compared to 2011, there is a novelty: for half of our public debt now the redenomination option has substantially vanished, due to the Collective Action Clauses (CACs) introduced by the ESM's establishing Treaty in late 2012. A serious discussion about the debt requires to have a look at its dynamics over the last 20 years. Let's just consider Italy and Germany as the two case studies. If we analyze the debt's breakdown by sector (public *versus* private), we realize that the overall leverage of the Germanic system has grown by just 10 points of GDP in 20 years. Unfortunately the picture is not the same for Italy. Despite the austerity and the fiscal consolidations, the overall leverage has grown by 60 point of GDP in 20 years. And it is not only the public debt to be determinant. Actually, an important part of this dynamic comes from the private sector.

Let's me spend some more considerations about the public debt and specifically about the German debt. At a certain point in time (2007-2010) it was higher than the Italian one, in absolute terms obviously. But after 2011 when the crisis was biting a lot, Italy has overtaken Germany. Why we arrived there and have these dynamics? There are several aspects, including the financial crisis imported the US, followed by the speculative attacks or (as I prefer to call them) the "*divergence trades*". But also the incomplete architecture of the euro has played an important role. At the launch of the single currency, financial markets believed in a Eurozone based on the principle of risk sharing. And they bet that all countries of the Monetary Union would have had a common yield curve. But, after the countermand arrived with in October 2010 with Franco-German meeting in Deauville and the subsequent ECB's decisions (including the discrimination of collaterals issued by the different governments of the Euro area), markets revised their view and began to bet on divergence. It's not a mystery. So we have been forced to recognize the poor resilience of the Eurozone's architecture. And – what is more important – the inability of deploying suitable unconventional measures of monetary policy. In fact, the ECB's extraordinary interventions have been marked by risks' segregation. As a consequence, some countries have been able to raise funds – both in the public and in the private sector – at very low interest rates, if not negative; while other countries have lost the *Germanization* of their interest rates. It was the end of the gentlemen agreement that had marked the beginning of the euro.

Because the euro starts on a very big agreement – I mean for countries like Italy with a huge public debt – the entry into the single currency has delivered low interest rates. So, somehow we were aware that the euro would have been a currency stronger than the lira and that this would have been risk for our manufacturing industry, but also we knew our problem with a big public debt and we thought that we would have been able to manage this problem lowering the funding costs of our Government. At the same time Germany was aware that with euro they would have had a currency weaker than the Deutsche mark and that this would have benefited their mercantilist economy. Hence, this implied swap of benefits (low interest rates in exchange for a weak currency) had been the gentlemen agreement at the foundations of the euro.

But this equilibrium is blown with the arrival of the crisis which has dramatically increased funding costs in peripheral countries like Italy, enterprises' bankruptcies, unemployment, with the consequent collapse of the manufacturing output and of the internal demand for goods and services, the boom of the non-performing loans, the credit crunch and other critical issues for both banks and industry. Our banks were forced to nationalize the public debt. Not only to absorb the excess-supply of Govies due to the deleveraging of German and French banks. Actually, it was also a side effect of the ECB unconventional interventions. Think about the €1,000 bn of *Long Term Refinancing Operations* (LTROs) deployed by ECB between December 2011 and February 2012: the private sector was required to use these huge liquidity injections to buy domestic Govies. In the same manner, a few years later, National Central Banks of Eurozone countries were required to continue this nationalization process with the Public Sector Purchase Programme launched by the ECB within its Quantitative Easing.

And then there is the NPLs' issue. It is not a mystery that in a bank-centric system if a firm goes bankrupt, it becomes insolvent and the bank has a problem. Of course, in Italy we have also other issues. Our banks have unwisely lent money to borrowers who were clearly unreliable and we know that this problem is definitively present. It is not by chance that the NPL ratio of Italian banks is overwhelming, much over most of other Eurozone countries. But definitively it is part of the game that the crisis hurts the banking system. Figures are impressive: according to Bank of Italy, at the end of

2016 net NPLs amount to €173 billion, of which €81 billion are classified as bad loans, €85 billion as unlikely-to-pay and €7 billion as overdrawn and/or past-due. And the European regulatory framework actually does not move towards fixing these issues but rather increasing the segregation of public and private debt's risks within each country.

Let me tell you something about burden sharing, bail-in introduced with the BRRD and the absence of European-wide deposit-insurance schemes to protect deposits even if they are one of three pillars of the agreement on the Banking Union that we have signed. As far as I know, usually when you have signed an agreement with three clauses, all of them should enter into force: here, instead, it's not the case. And now Eurocrats are discussing about introducing limits on large sovereign exposures, and applying risk weights on Govies, ESBies will be used to manage the exit from the Quantitative Easing and the ECB strongly recommends banks to accelerate NPLs' disposal (no matters if the sale price is much lower than the net book value). So if you would be an investor, an institutional investor, a hedge fund on what you would bet? Obviously you would bet on the dissolution of the Euro, and would build up some strategy to make profits from the expectation that sovereign spreads will rise again until the point when the ECB will be forced to intervene in order to narrow them. The basic strategy (sell Italy-buy Germany spot plus buy Italy-sell Germany forward) would deliver an easy gain, what I call "*spread-based intermediation*".

Let's now spend some words about the productive system. Since the outbreak of the crisis in Italy we have lost ¼ of our manufacturing output. A lot of the firms involved were definitively inefficient, we have to say this. Usually the crisis "cleans" the system. But surely there have also been firms which have been denied access to just that €1 of credit they need to remain on business. And the credit crunch isn't the only problem. Due to the lingering breach of the paradigm "*one currency, one interest rate term structure*", large competitive gaps plagued our industries, forcing them to pay higher costs to fund their production w.r.t. their German competitors. Let me share an example and some figures. We have two companies, one established in Germany and one in Italy, which sell the same product outside the Eurozone. If we compute the difference in funding costs between these two companies over the last years, we observe a difference of the 30% which is obviously translated into the price of their products. How can you compete in this environment? You cannot do anything but devalue the cost of labor which is exactly what we are seeing. Because – due to the common currency – you cannot rely on exchange rate adjustments to re-balance competitive gaps, and so the cost of labor is the only tool that we have, in a spread-based economy, to try regaining some competitiveness.

This is only a part of the story. The second part is the fall in public investments and, in general, in investments despite they are a key GDP contributor. Indeed, according to the Fiscal Compact, productive investments deserve the same treatment as unproductive expenses. This is a nonsense, it is like the sovereign yields' spread within a common currency area. But unfortunately these are the rules: over the last three years we have managed the Fiscal Compact in a fanciful way in our budgetary laws. But the reality is that, with the Fiscal Compact, every year, the room available for public investments declines and you cannot do nothing. To be compliant with the new constraints the Government had had to introduce the so-called *safeguard clauses* in its budgetary laws, providing for an increased tax burden (e.g. VAT hikes) over the next years should the public spending have been higher than the planned amount. As a consequence, every year a large part of the fiscal stance is devoted to find the funds needed to de-activate the pending *safeguard clauses*: the first year the impact of these clauses was the 10% of the total planned Government spending and it has increased over time until reaching the

current level of 61% of the total public expenditure, leaving almost no room to fund public investments and infrastructures. How can you manage the situation? You cannot. And these rules are quite well enforced while there is not enforcement at all with regard to the trade surplus of Germany. Despite it clearly being something abnormal and cause of serious macro-economic unbalances within our currency area, Germany receives only useless reprimands by the Euro-bureaucracy. And what is funny (actually not really funny but quite sad, I would say) are the letters of the European Commission containing the recommendations addressed to the different Eurozone member countries. Obviously these letters have to be in line with the rules; so I am not criticizing the EU Commissioners, but it is funny to read something like that: "*you have to increase labor cost and you have to make public investments*". And since Germany has €14 bn of budgetary surplus, it will surely obey these recommendations. That are exactly the recipe needed like Italy because of the fall of our manufacturing output comes from the scarcity of investments. It is not only a problem of lowered consumptions. And, on the investments' side we are unable to take proper actions because of the "safeguard constraints" established by the Fiscal Compact: it's a vicious loop.

In Italy a large part of investment spending comes from central Government (now de-activated by the Fiscal Compact) and by local entities such as municipalities and Regions which, in turn, over the last years local entities have found strict constraints due to the internal stability agreement. So you cannot move because you receive some room for manoeuvre from the Euro-bureaucracy on the one hand but unfortunately you are stuck on the other. Of course, one could comment that last year we ha d the opportunity to make more investment spending for an amount corresponding to the 0.5% of our GDP (really peanuts) and yet we have not been able to exploit this possibility. True. And, in fact, a problem of our country is also with the capabilities of its ruling class, but definitively the EU rules do not help at all.

The main synthesis of the picture described so far, of the unacceptable divergence between economies and countries which belong to the same currency area is offered by the balances of the Target 2 System: Italy has the largest negative balance (€422 bn) while Germany boasts the largest surplus (€ 857 bn). Said otherwise: we are the most indebted country and Germany the largest creditor in the Eurozone.

Proposals? Solutions? In my opinion risk sharing should become the founding principle of the Eurozone, the benchmark of our common currency area. And (believe me) this would not be an issue for the European Treaties. I disagree with those who argue that we should change the Treaties. If you read the Treaties, you'll find the risk sharing principle there. Rather, subsequent agreements have subverted this principle. If you have a look to the Fiscal Compact and compare recitals and articles with the technical appendix, you see that these two parts of the document were written by two people that do not speak one each other. Because recitals and articles prescribe that the fiscal agreement should operate in a counter-cyclical manner but the algebra of the appendix is pro-cyclical. So, maybe that the lawyer that wrote the law did not speak with the economist who wrote the algebra, or maybe that they were from two different Eurozone countries. I don't know.

The big question is how to restore consistency between the risk sharing principle and the rules that are already enforced within the Eurozone.

First thing: an anti-spread shield. It has to be updated in its view and activated in order to pursue a zero-spread target among Eurozone sovereign issuers by the next twelve months. Believe me: no institutional investor would bet against a such commitment if agreed among member countries and

credibly pursued by the ECB. And in twelve months markets would implement "*convergence trades*", as they did over the three years before the starting of the Eurozone. If they have the chance to make money for free, why they shouldn't bet on it? Notice that without the spread we would restore the fairness of the competitive arena within our currency area. Not so bad!

Second thing: the risks of the public sector bonds purchased under the Quantitative Easing should be shared. How to achieve this? The domestic Govies purchased by the National Central Banks should be sold to the ECB and stay in its balance sheet for a while.

It's a way to create synthetic Eurobonds, not European safe bonds (ESBies). I am sorry.

Third thing: a European bad bank to solve the problem of €1,000 bn of NPLs of the European banks. We need a smart securitization scheme in order to definitely fix the issue.

Fourth: a pan-European fund to protect banks' deposits. It is already envisaged by the agreement on the Banking Union. Let's make it true. We have the single supervision, the single resolution mechanism, the bail in. We also need the European deposit-guarantee fund.

Fifth: an intervention measure to relaunch troubled firms with liquidity/insolvency problems. I call it "*firms' bailout*". Let me explain what I mean. A synchronization between bank and business accounting. The value of the liability resulting from the balance sheet of the firm must correspond to net value of the claim written in the balance sheet of the bank. The underlying rationale is that the collectivity has already paid for the tax cut associated with the insolvency of the firm by allowing banks to write Deferred Tax Credits in its balance sheet.

Further required interventions would be the revision of the Fiscal Compact to exclude investment spending from the calculation of the structural balance and, more in general, to make the algebra of this agreement consistent with its counter-cyclical aims. In addition, also some Targeted LTROs should be addressed to selected Eurozone countries in order to remove inflation gaps which – just like yield spreads – feed competitive distortions. After all, it's a fundamental principle recognized by the EU Treaties: that the competition should be absolutely fair.

These are the requisites for a Eurozone 2.0. Inertia or, worse, perseverance with on risk segregation policies would amplify the market attitude to bet on the economic and financial divergence of the Eurozone countries because of the risk-free profits guaranteed by the "*spread-based intermediation*". The uniqueness of the currency definitively gives more strength to a, say, standard fixed exchange rate regime, but we cannot ignore that sooner or later similar regimes, if just we study the history, collapse under the pressure of centrifugal forces.

I thank you all for the attention.