Ignazio Visco: How to react to the fragmentation and the slowdown of the EU economy?

Opening remarks by Mr Ignazio Visco, Governor of the Bank of Italy, at the Eurofi Financial Forum 2014, Milan, 11 September 2014.

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Ladies and Gentlemen, it is a pleasure to join Jacques de Larosière in welcoming you here in Milan. This event occurs at a crucial juncture for the European project and I hope it can be useful to shape our minds on what needs to be done. On my side, I will offer some thoughts on the current economic situation in the euro area and on the actions that are in my view most urgently needed.

1. Economic situation in the euro area and the monetary policy response

Let me start by briefly recalling the latest macroeconomic developments.

In the euro area recent data indicates that growth perspectives remain subdued and economic weakness is no longer confined to countries under stress. Amid ongoing geopolitical tensions, the stimulus provided by exports may be losing momentum, while domestic demand continues to drag because of the contraction in gross fixed capital formation.

Confidence indicators worsened in recent months. Among firms, the deterioration is particularly pronounced in the manufacturing sector, owing to the heightened uncertainty on world trade. Households' confidence is affected by the persistently weak conditions in labour markets, with too high rates of unemployment in the euro area at large. The overall outlook is still consistent with a moderate growth of economic activity in the second half of the year, but downside risks have clearly increased. Last week, the ECB revised downwards the projections of GDP growth for the next two years.

Since Autumn 2013 inflation has been declining at a pace faster than expected, prompting continuous downward revisions of forecasts. In August the headline inflation rate was as low as 0.3 percent in the euro area and has turned negative in a number of countries. Declining inflation reflects not only the fall in energy prices, compounded by the past appreciation of the euro, but also the persistent weakness of the economy. Core components are in fact proving to be increasingly sensitive to the prolonged slackness in domestic demand.

Medium-term inflation expectations have decreased markedly. At the end of August, based on inflation swaps, 1 and 2 year-ahead expected inflation rates were, respectively, at 0.8 and 1.1 percent; only at horizons as far as 2022 does expected inflation appear to be consistent with the ECB definition of price stability. With declining, even negative, inflation rates the consolidation of public and private debt is more difficult, while persisting nominal rigidities hamper the adjustment of relative prices.

This difficult situation is aggravated by persistent divergences among countries. Fragmentation of financial markets along national lines in the euro area has progressively receded after the announcement of the OMT programme in the summer of 2012, but is still present. Firms' and households' borrowing costs in stressed countries are still higher than average, mainly reflecting the larger credit risk. For example, in July the cost of new bank loans for Italian non-financial corporations remained 60 basis points higher than the euro area average.

The response of monetary policy has been wide-ranging. Last week the ECB's Governing Council decided to further cut policy rates to new unprecedented levels, basically reaching the zero lower bound for the Main Refinancing Operations; it also launched two asset-purchase programs (entailing ABS and covered bonds), which together with the Targeted

Longer-Term Refinancing Operations decided in June go clearly in the direction of fully restoring the monetary policy transmission mechanism and supporting the provision of credit to the broad economy.

2. Macro-prudential policy can support the monetary policy task

Averting the risk that a too-prolonged period of low inflation would eventually lead to a dis-anchoring of medium-term inflation expectations is paramount. If needed, further monetary policy actions can be undertaken.

Of course, we are well aware that, as the crisis has dramatically revealed, a prolonged period of low interest rates may fuel financial vulnerabilities and imbalances. In a monetary union with diversified financial conditions, tensions may emerge in some countries or in specific market segments or asset classes.

However, compared to the past, in the present circumstances monetary policy has a powerful ally: macroprudential policy. In the European Union, with the new powers resulting from the entry into force of the CRDIV-CRR package, national authorities now have at their disposal an array of instruments to tackle localized emerging pressures. Indeed a number of countries have already started to act, in particular to address pressures in real estate markets.

The new framework ensures also a Europe-wide leg for macroprudential policy, with a view of addressing potential negative spillovers of country-specific measures. The European Systemic Risk Board is tasked with monitoring and assessing systemic risks at EU level and represents the European forum where national authorities can discuss and coordinate their positions and policies. Moreover, the SSM Regulation has empowered the ECB with specific macroprudential tasks, such s the possibility to directly apply more stringent capital buffers to banks, as well as with a coordinating role within the euro area.

Overall, there appear to be no constraints for monetary policy to continue providing the required stimulus to the euro area economy. At the same time, we know that the use of macroprudential tools as a leaning-against-the-wind response to the accumulation of financial risks depends on both the instruments used (e.g., countercyclical capital buffers, Loan-to-Value or Debt-to-Income ratios) and the targeted sector/asset class (e.g., real estate, corporate bonds).At any rate, even more than to counter the building-up of financial imbalances in the face of shocks, macro-prudential measures should be effectively used to increase the resilience of the financial system.

3. Financing investment and the recovery

Following deep financial crises, economic recovery has always been slow to materialize. However, the disappointing economic performance in the European Union goes well beyond previous experiences. At the heart of the problem is the weakness of aggregate demand, in particular investment.

Since the beginning of the global crisis, in the euro area public and above all private investments have collapsed, by 20 percent in real terms over 2007–13, more than in the European Union. In Italy the fall was even larger, by more than25and 30percent, respectively, for private and public investment. Reviving investment – public and private, national and European – is critical in order to jumpstart recovery.

Several factors held back investment; among them:

– widespread uncertainty about prospective demand growth;

– deleveraging by over-indebted firms;

– difficult access to credit.

Today's overarching goal is to make the business environment more conducive to investment. Besides the implementation of country-specific structural reforms, which is of critical importance, investment requires supportive financing conditions. The Italian Presidency has placed this theme at the top of its agenda.

To foster investment and to improve access to credit, four priorities stand out:

- reducing the cost of capital;
- reviving securitization;
- developing capital market sources of finance;
- investing in infrastructure.

Let me briefly discuss each of them in turn.

Reducing the cost of capital

The latest indicators of credit supply display some signals of improvement in lending conditions. The Eurosystem Bank lending survey shows that, in the second quarter of 2014, euro area banks, including Italian ones, reported a net easing of credit standards on loans to enterprises for the first time since the second quarter of 2007. Credit terms have been eased for households too, following a trend which started at the beginning of the year.

While these signals are encouraging, there is still significant room for improvement as credit standards remain tight compared to the pre-crisis years, also in countries that did not experience any credit boom before the financial crisis.

As mentioned, monetary policy is doing its part to reduce the cost of capital and secure more uniform credit conditions across the monetary union. An important contribution to sustain and accelerate the flow of credit to the economy will come from the TLTROs, as they contain specific built-in incentives for banks to on-lend to the private sector the funds obtained from the Eurosystem. Our own estimates for Italy show that if banks fully took up the additional funding and passed on the cost advantage to borrowers, the beneficial impact on GDP could reach 0.5 percent, a sizeable amount.

The completion of Banking Union, including a smooth start of the Single Supervisory Mechanism and a swift implementation of the Single Resolution Mechanism, together with the continuation of an ordered process of balance sheet repair at European banks will help ensure the full functioning of credit markets. Beyond Banking Union, it remains critical to address country-specific macroeconomic risks and vulnerabilities, such as weak competitiveness and current account imbalances, as well as to ensure sustained progress towards sound and sustainable public finances.

Reviving securitization

Reviving securitization has been long recognized as an essential complementary instrument and several initiatives have been debated (also in a joint paper by the ECB and the Bank of England) to revive this market.

In particular, it is necessary that simple and transparent securitizations be defined, and then promoted, in a consistent way across the EU. Furthermore, a set of common rules applicable throughout the financial sector should aim to avoid arbitrage opportunities across financial intermediaries and types of securities. Finally, more information on the characteristics of securitization and the underlying loans should be made available to investors.

In order to achieve these objectives, there is now a need to agree on an EU-shared regulatory framework for high-quality securitization.

Developing capital market sources of finance

From a medium-term perspective, it will be important to develop capital market sources of finance in order to progressively make euro area firms less reliant on bank credit. This would also contribute to a rebalancing of firms' financial structure after the fast increase in their leverage during most of the past decade in several euro countries.

The Italian Presidency's agenda emphasizes the development of capital market sources of finance and of non-bank financial intermediaries (venture capital funds, debt funds, European Long-Term Investment Funds – ELTIFs). In the face of the several valid proposals that have already been put forward, notably by the Commission, this agenda thus offers a good starting point towards selecting a well-defined set of priorities and moving to the implementation phase.

A first important lever is to provide non-financial firms with incentives for more equity financing, which allows them to better undertake medium and long term investments, including those in research and development (best financed by risk capital), while decreasing their financial vulnerability. Taxation may play a key role in providing these incentives. For example, the use of an allowance for corporate equity (ACE), which allows corporations to deduct a notional return to new shareholders' equity, reduces the tax advantage of debt funding while generally implying, due to its incremental nature, only a limited loss in tax revenues (an ACE was introduced in Italy in 2011 and reinforced in 2013 and 2014.)

Increasing non-bank sources of finance for the economy, and specifically for SMEs, also requires the development of financial intermediaries such as equity and debt funds, closed-end funds that invest in loans, bonds and shares issued by unlisted companies. This semester could see the final approval of the Regulation on European Long-Term Investment Funds, a major step to stimulate their activity across Europe.

Investing in infrastructures

Along with country-specific structural reforms on the supply side, broader economic policy action is required to accelerate the building-up of infrastructure, both tangible and intangible, indispensable to the success of a true Single Market.

The financing of infrastructures and the proposal for an EU plan of public investment require a more efficient use of public resources along with greater involvement of private funds. To this end, euro project bonds, public-private partnerships, infrastructural funds and public guarantees could be the instruments to lever on private investments.

Strengthening the role of European Union's financing institutions (EIB, EIF) and improving the coordination among national investment banks should be essential parts of the process to ensure the development of efficient and well-functioning infrastructure networks, which represent the backbone of prospering economies.

4. European integration as the ultimate way out of the crisis

To conclude, let me reiterate that a substantial strengthening of the EU recovery, one that would go a long way towards the definite exit from the crisis, cannot be achieved by the isolated actions of individual economic policy authorities. In particular, monetary policy alone cannot revive growth and guarantee financial stability in the euro area if the problems underlying the crisis are not resolved at both national and European levels.

The return to sustained and balanced growth requires broader economic policy action centered on investment – as I said, private and public, national and European – which is the linkage between today's demand and tomorrow's supply. The favorable financial conditions that both monetary policy and Banking Union are ushering in must not be missed.

From a longer-term perspective, we need to resume the process of European integration, while recognizing that it is a long and arduous one, and far from being linear. The debate on the euro area's "fiscal capacity" needs to be restarted. Beyond the important achievement of the Banking Union, it is essential to continue resolutely along the path to a fuller Union.

Let me conclude by emphasizing once again that the benefits of strengthening European integration far outweigh the alleged advantages of weakening it. Choices must be made responsibly. The risks of inertia far outweigh those of action.