Ignazio Visco: Launch of the OECD Business and Finance Outlook

Special address by Mr Ignazio Visco, Governor of the Bank of Italy, at the Launch of the OECD Business and Finance Outlook, Paris, 24 June 2015.

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I first wish to thank the Secretary General for kindly inviting me here today.

The OECD Business and Finance Outlook is a welcome newcomer that complements available analyses on the global economy's macro-financial outlook published by international organizations. It adds, in this first issue, a distinct perspective by bringing together a number of topical issues that define the current situation of very low interest rates. I also like the focus on business investment and its financing channels in the post-crisis environment, and I agree on the relevance of the report's key findings.

Before learning more details from Adrian Blundell-Wignall's presentation, I would like to offer just a few remarks, not least because the report's starting point – record-low interest rates – is also very much affecting central banks' actions in response to the global financial crisis and especially, in the euro area, the sovereign debt crisis.

The Governing Council of the ECB has been confronted with the risks stemming from a prolonged period of exceptionally low inflation, if not outright deflation. These risks are considered particularly high in the current conditions of policy rates at historical lows, possibly marked disanchoring of inflation expectations, and high levels of public and private debt. The response has been to launch an expanded asset purchase programme designed to bring about a sustained adjustment in the path of inflation consistent with the return to price stability, that is an annual growth in consumer prices of below but close to 2 per cent in the medium term.

Potential repercussions for specific sectors, such as those considered in the new OECD Outlook, are not being ignored. There are no signs, for the time being, that low interest rates are provoking generalized imbalances, or that asset and property prices are subject to particular speculative pressures. Local and sectoral tensions may occur, but they should be controlled with well-designed macro-prudential measures. Moreover, the exposure of institutional investors to a prolonged period of very low interest rates may be significant in some euro-area countries, but it should be limited through better matching between yields and duration of balance sheet assets and liabilities, improved operating results through portfolio diversification, augmented technical reserves, and the adjustment of contractual obligations to policyholders.

In short, the risks, both real and financial, would have been far greater had we not taken the nonconventional measures in 2014 and early this year. The greatest threat to the euro area's financial stability comes from the prospect of a combination of excessively low inflation and stagnating activity that the ECB programme aims to overcome.

Indeed, there is, and not limited to the euro area as clearly observed in the Outlook, a substantial disconnect – the "greatest puzzle" of today's global macro-financial setting – between a reluctance to take *economic* risk, resulting in the still subdued recovery of business investment, first and foremost in advanced countries, and a high propensity to take *financial* risk, as epitomized by high asset price valuations and compressed spreads. A better balance between financial and economic risk taking is the key to faster growth but it is itself fraught with risk. It rests mostly on complementary policies, including monetary and macro-prudential ones, and especially on structural reforms that respond to the many challenges coming from a globalized environment and substantial changes in technology.

The Outlook helps to shed light on a question we are all asking: how is it that today's very favourable financing conditions have been little able thus far to foster a substantial recovery of business investment (which we all know is a precondition for growth and job creation).

Uncertainty has long been identified as the main culprit, but the report adds value by highlighting the role played by such factors as strategies of multinational enterprises, participation in global value chains, and incentives to short-termism not only for companies but also for institutional investors.

Here is where I find one of the report's distinguishing features, a methodological one, namely that the analysis of the recent evolution of business investment is conducted using data on a large number of the world's biggest corporations, thus complementing other analyses of a more macroeconomic nature. Also interesting is the contrast noted between the still subdued recovery of business investment in advanced economies and the signs of over-investment in the general industrial sector of many EMEs (not only China).

By taking the current levels of low interest rates as a starting point, the report links this short- to medium-term feature with important longer-term themes such as population ageing and the sustainability of (public and private) pension and healthcare systems. New and old financial risks are appropriately discussed, risks generated by such key developments as the growing size and importance of institutional investors, their potential engagement in excessive search-for-yield, and the challenges to their longer-term financial soundness, including from longevity risk.

Besides, the Outlook places a premium on the analysis of the impact of recent structural changes in the banking sector on the cost and availability of finance for growth. The analysis confirms that these changes, along with the more stringent international regulatory and supervisory framework for banks, are set to open up "bank lending gaps" outside the US, most notably for SMEs, while at the same time working as key drivers of regulatory arbitrage and the expansion of the "shadow" banking sector.

This is an area where policymakers face a new trade-off: on the one hand, there is a need to develop alternative non-bank financing sources, chiefly for European SMEs; on the other, one should contain the distinct risks to financial stability posed by a growing shadow banking system, whose funding mechanisms are more prone to create leverage and counterparty exposures. These are issues on which there is substantial regulatory and policy attention, not least by the Financial Stability Board. It should lead to principles and practices that increase transparency and allow, especially in Europe, new direct and indirect ways for capital to flow towards promising investment projects.

The Outlook calls for a two-pronged strategy of restoring banks' health and developing alternative market-based sources of financing for investment, a prescription clearly in line with recent European initiatives. The challenge is to make it work, and we should all be engaged in this effort. In the European Union this means unifying, rapidly and wisely, our capital markets as well as helping sound and profitable cross-border financing to flow smoothly to the common benefit, without short-sighted barriers. But I also share the emphasis on the need to consider country-specific features when it comes to identifying approaches and instruments most appropriate to improve SME financing.

The interdependence and counterparty risks in the financial sector are still being regarded in the Outlook as the greatest threat to financial stability. That this is still believed to be so is a sad conclusion, as it seems to imply that not much has been achieved since the eruption of the global financial crisis in terms of the regulatory set-up and the practice of policymaking. I only partly share this conclusion, as I believe that in many fields solid progress has been obtained.

The report seems to link these risks mainly to the lack of a strong separation of regular retail banking from such activities as prime broking and custody and collateral management services. It goes as far as stating that "in this respect, the Volcker rule, Vickers and European legislation did not go far enough". I am sure that more could be done in this field, and I look forward to it, but I would also like to warn against an excessively formal approach. The real challenge is to avoid conditions such as "too-big-to-fail" and "too-interconnected-to-fail". I

observe, in this respect, that the awareness and the strength of supervision (not only regulation) have much risen in recent years.

Finally, I certainly subscribe to another of the report's policy prescriptions for encouraging "compensating investment", such as in R&D and social infrastructure, to offset the tendency of multinational enterprises to shift production, notably in the manufacturing sector, away from advanced economies, even if some reversal is currently occurring. And I cannot help but share the point made by Angel Gurría in his Editorial, that addressing the multifaceted long-term challenges posed by population ageing ultimately requires business investment, notably in R&D and innovation, that supports productivity and economic growth. Policymakers therefore need to ensure framework conditions that are most conducive to stronger capital formation.

To conclude, identifying and monitoring old and new risks is a key ingredient for effective crisis prevention. The Business and Finance Outlook that the OECD is launching today promises to provide analysts and policymakers with an additional tool that offers distinctive but complementary perspectives with respect to other established, useful and time-honoured outlooks and reports, such as the OECD Economic Outlook, on which I spent so many hours over the years in this very location, with colleagues I will always remember with nostalgia and affection.