

## Ignazio Visco: “Doing Business in a Fragmented World”

Keynote speech by Mr Ignazio Visco, Governor of the Bank of Italy, at the Launch of the OECD Business and Finance Outlook and High-Level Roundtable “Doing Business in a Fragmented World”, Paris, 9 June 2016.

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*I first wish to thank the Secretary General for his kind invitation to me to be here today.*

As a general comment, let me say that this second issue of the Business and Finance Outlook confirms its character compared with other long-standing reports. It provides valuable in-depth analysis of many topical themes that are critical for a better understanding of the current dismal outlook of the world economy. I find particularly interesting the relationship between corporate finance and productivity, the role of R&D expenditure, the issue of stock market fragmentation, and the implications of heterogeneity of life expectancy across socioeconomic groups. The multifaceted dimensions of the cross-cutting theme of fragmentation are investigated thoroughly. The analyses are backed by rich and original information. For all of these reasons, I wish to congratulate the OECD for this very interesting document.

I would like to offer some remarks on a few topics that caught my attention most greatly. Admittedly, this selection was not easy, given the abundance of issues and findings.

The report singles out two headwinds to global growth: the reversal of the commodity supercycle, against a backdrop of excess supply capacity and high corporate debt in some emerging market economies (EMEs); and the still modest recovery in advanced economies, associated with two key legacies of the crisis, deleveraging and high non-performing loans.

On the policy front, the main challenge identified by the report remains – unsurprisingly – the same as one year ago: how to revive firms’ appetite for *economic* risk-taking – the entrepreneurs’ “animal spirits” that drive long-term investment projects – so as to fill the gap with *financial* risk-taking, stimulated by strongly expansionary monetary policies.

According to the report, what is needed is a phase of “creative destruction”, characterised by a reallocation of resources towards productivity-enhancing investment and a reduction of excess capacity in sectors such as energy and materials. Structural reforms are seen as the key policy measures with which to accompany this process in both advanced and EMEs. As a result, global growth would accelerate and monetary policy would normalise “safely”. Absent sizeable structural reforms, the main risk would be what the report calls an “inflation-first” scenario, where a rise in inflation would eventually force central banks to increase monetary policy interest rates, which in turn would prevent an acceleration of economic activity.

I fully support the report’s emphasis on the importance of structural reforms to place the global economy on a sound footing and to make markets work better. In fact, the crisis has clearly shown the limits of the self-regulatory capabilities of markets, particularly financial markets, and their consequences on financial and, ultimately, macroeconomic stability. I also agree with the report’s main policy advice, centred inter alia on investments in R&D and incentives for equity financing over debt.

However, in order to ensure an orderly adjustment of the global economy and to allow structural reforms to rapidly kick-start the real economy, appropriate macroeconomic policies are also needed.

In this vein, I do not share the report’s negative assessment of the current monetary policy stance that would be “harming the prospects of a sustainable recovery”. This view – which appears not in line with the one expressed in other recent OECD assessments and policy

suggestions – seems to me to overlook the reasons behind the current monetary stance, while focusing too much on the possible unintended consequences.

In a context of very low commodity prices and long-lasting weakness of both global and domestic demand, in advanced countries disinflationary pressures and slack in the economy are still high, although with differences among the main economies. Under these circumstances, a wait-and-see approach to monetary policy would be unwarranted: rather, central banks observe economic developments, ponder risks and may need to act forcefully. The current low level of policy rates is the appropriate reaction to current cyclical conditions, not an arbitrary choice of central banks; a less accommodative stance, particularly given the high debt levels as a consequence of the crisis, could lead to a deflationary spiral with severe consequences both for the real economy and the financial sector.

This holds true in particular for the euro area, where unused productive capacity and labour are greater than in other advanced economies. Estimates by Banca d'Italia staff (which do not consider further possible non-linear effects) show that in the absence of the measures adopted by the ECB Governing Council between June 2014 and December 2015, both annual inflation and GDP growth in the area would be lower by about half a percentage point in 2015–17.

Of course, a very accommodative monetary policy for a protracted period involves risks that need to be monitored carefully. The report considers the impact of low interest rates on investors' portfolio choices, noting the rising importance of private equity, hedge funds and real estate investment funds. This analysis highlights that too-low-for-too-long interest rates may spur asset price bubbles and may also stimulate short-termism among investors, i.e. by favouring companies that offer cash-like returns at the expenses of companies that focus on longer-term investment projects. In this respect, let me just observe that portfolio rebalancing that would encourage a higher degree of risk taking is one of the intended channels of transmission of non-standard monetary policies and that currently there are no indications of a generalised overvaluation of financial or real assets in advanced countries. Should excessive risks emerge, targeted macroprudential policies can be used as appropriate.

Clearly, monetary policy is not the solution to structural problems (and, as we often say, cannot be the "only game in town"). But I do believe that an expansionary monetary stance creates more favourable conditions to implementing structural reforms: it stimulates aggregate demand and may reduce the possible short-term macroeconomic costs of reforms while helping maintain the necessary political drive and foster consensus regarding their adoption. In the same vein, monetary policy cannot be left alone in the effort to support the economic recovery; it must be complemented by an appropriate use of available fiscal space, with appropriately targeted, growth-enhancing measures, such as investment in infrastructure.

On structural reforms, let me also point out that, while increased competition in product markets and more flexibility in labour markets remain important for the enhancing of an economy's ability to withstand shocks and recover quickly, when designing reforms, it becomes critical to take into account issues such as those raised in the debate about secular stagnation, as well as the structural trends triggered by innovation. For example, it is essential to consider the impact of the digital revolution on both labour demand, which has raised fears of a re-emergence of Keynes' technological unemployment, and income distribution, as highlighted by James Meade already in 1964. This puts a premium on measures to favour investment in education, life-long learning, training and active labour market policies.

Moving on to the fundamental issue of productivity, the report carries out a very detailed analysis of the somewhat puzzling fall in aggregate productivity growth in the aftermath of the crisis. This holds true for non-financial companies in both advanced countries and, above all, EMEs. The firm-level analysis highlights a structural change in the evolution of productivity across companies and sectors: from a single cutting-edge group of "incumbent" companies

displaying high levels – but low or negative growth rates – of productivity to the emergence of a second group of “high-growth” companies characterised by faster productivity growth. This finding suggests that it is critical to understand the drivers that underlie these changes.

The report rightly emphasises the impact that corporate finance decisions may exert on productivity. Four financial strategies are identified that make a difference between high and low productivity growth at a company level: higher spending on R&D; lower debt-to-equity ratio; higher free cash flow; and more M&A deals. The analysis sheds lights on critical macro-financial linkages. What I find very instructive is that these strategies are all part and parcel of the structural policies that are called upon to trigger economic risk-taking, investment and ultimately growth.

As far as financial markets are concerned, two fundamental drivers of change are technology and regulation. This is well documented in the chapter of the report on stock markets, which I find particularly insightful. Here, there seems to be an issue of finding the right balance between the advantage of having more numerous and more specialised trading venues and the disadvantage of fragmenting trading liquidity. The possibility to trade a listed share in various markets promotes competition among providers of financial services. The availability of “dark” trading venues (i.e. with little transparency in pre-trade information) seems to allow institutional investors and other large players to place sizeable orders without giving rise to adverse price changes. On the other hand, it is important that such “dark” trading pools do not undermine a level playing field and a correct handling of conflicts of interest. Putting the various types of trading venues on a more even footing is the objective of some recent regulatory initiatives in advanced countries. The availability of consolidated real-time price and volume data to market participants is another important factor.

The report also considers under the notion of fragmentation issues related to the fundamental heterogeneity of economic agents and conditions. A case in point is life expectancy, which varies greatly (both in levels and trends) across individuals depending on socio-economic factors such as education, income and occupation. The report argues that, in regulating retirement, such heterogeneity should be taken into account. The suggested policy implications – namely, improving the measurement and management of longevity risks, broadening the range of annuity products, and tailoring pension arrangements to the various segments of society – have actually long been advocated by the OECD and in other policy fora. What I think should also be underlined is that the development of targeted payout products such as enhanced annuities would also alleviate the pension adequacy problem recently highlighted by the OECD *Pensions at a Glance* report.

Let me conclude with a few thoughts on some broader trends that are of major interest for economists and policy-makers alike. Current demographic developments are widely seen to act as a negative labour supply shock that would reduce future global growth via lower investment and productivity; this could also result in further downward pressure on real interest rates. On the other side, growth is expected to benefit from technological innovation and its positive impact on productivity, although this view is itself disputed by the advocates of the supply-side version of the secular stagnation hypothesis. All these dynamics will also affect income distribution and may fuel already rising inequality. The interrelations among the above key variables may not be fully understood at this time, much less predicted; for sure, they are set to raise critical real and financial implications that require in-depth analysis in future reports.