

Robert Holzmann: Normalization of monetary policy - challenges and outlook

Speech by Dr Robert Holzmann, Governor of the Oesterreichische Nationalbank, the Austrian central bank, at a reception of the Austrian Embassy, London, 29 April 2024.

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Dear Ambassador, honorable guests,
ladies and gentlemen,

Thank you for the invitation to today's reception in the residence of the Austrian Embassy and the chance to deliver some food for thought in addition to the food for the body, which is provided by the Embassy, and which is equally important.

Let me quote Winston Churchill at the beginning of my deliberations, who famously said: "I am an optimist. It does not seem too much use being anything else."

There are certainly many reasons to be optimistic about ongoing global and structural developments, such as the opportunities from artificial intelligence, or the increasing awareness and efforts to achieve a successful green transition.

And having an optimistic attitude is certainly good advice for the two important challenges I will talk about in my speech. The first is normalizing monetary policy in a challenging environment, the second, fostering the capital markets union in the EU to make the European capital market as successful as the one in the United Kingdom.

But before I delve into these topics, I would like to say a few words on the current economic situation, as I returned from the IMF/World Bank spring meetings just a week ago, where central bank governors and finance ministers from all over the world discussed the economic developments and the challenges we currently face.

1. Global economic developments

At the IMF meetings, optimism, especially regarding the growth of the US economy, prevailed. However, despite global growth being resilient, it is uneven, with a robust development e.g. in the US and some emerging economies and weaker growth in Europe and the UK. Overall, the IMF projects growth to amount to 3.2% on a global level in 2024, with the euro area at 0.8% and the UK at 0.5%, respectively.

However, there are some significant downside risks which might hamper growth perspectives:

- Geopolitical wars and tensions, especially in the Middle East or Ukraine, could increase, putting pressure on trade and commodity prices.
- China is showing disappointing growth – despite an above-target performance in Q1 2024 – and structural challenges, e.g. in the property sector and regarding the impact of population aging, remain high.

- The stickiness of inflation might require current (high) rates for longer than previously expected.
- Some sectors in the financial system like commercial real estate or private credit could deteriorate.

Inflation is receding, and most advanced economies are forecast to reach 2% by 2025 by the IMF. The latest inflation results, e.g. for the US and the UK, point toward fewer rate cuts in 2024, and some market participants in the US even told us that they expect no rate cuts by the Fed in 2024 at all.

Labor markets remain strong, and unemployment is historically low. Especially in the US, the labor market is fueled by immigration, and migrants are integrated into the labor market quickly. International trade shows signs of recovering but is still far from pre-pandemic levels.

Risks are tilted to the downside, especially if disruptions in the Red Sea escalate.

However, some countries already face high fiscal deficits in parallel with high debt. In addition, 2024 is an important electoral year: 64 countries in the world elect their government. Thus, fiscal expenditure might go up and the results of elections, especially in the US, might alter geopolitics, trade and capital flows.

Besides the near-term challenges already discussed, other longer-term structural challenges remain:

- Weak productivity: total factor productivity is low, as well as innovation efforts.
- Population aging, especially in advanced economies. This puts pressure on the pension and healthcare system, reduces the workforce as well as innovation.
- Geopolitical fragmentation and conflicts, and their effect on movement of trade and capital.

These deliberations bring me directly to the first main topic which I want to discuss today:

2. Inflation and the normalization of monetary policy

As you all probably know, the Eurosystem increased interest rates 10 times to 450 basis points in the last two years to fight exceptionally high inflation. The Eurosystem's latest inflation number is 2.4% (Eurostat flash estimate for March) and a recent ECB forecast assumes inflation rates of 2.0% and 1.9% for 2025/26. So, we are approaching our target of 2%. Many financial market participants currently anticipate a first key interest rate cut in June.

However, let me reiterate that the ECB will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction.

In addition, the Eurosystem's balance sheet is shrinking due to the maturing of assets and repayment of the targeted longer-term refinancing operations – TLTROs. Overall, the consolidated balance sheet of the Eurosystem peaked at EUR 8.8 trillion in mid-2022. Since then, long-term loans from banks amounting to EUR 1.8 trillion have been repaid. In addition, securities acquired as part of the expanded asset purchase program (APP) are slowly maturing.

So, overall, the size of the Eurosystem's balance sheet has decreased by around EUR 2 trillion since its peak.

What comes next and what does the monetary policy framework of the future look like? You may have heard of the recent discussions in the ECB Governing Council on the operational framework. So, the Eurosystem is preparing for the period of declining excess liquidity and is adjusting its monetary policy framework accordingly.

- In future, the monetary policy stance will continue to be indicated mainly by the interest rate for the deposit facility; the interest rate corridor will be narrowed in September.
- Central bank liquidity will be provided through a mix of regular credit operations (with one-week and three-month maturities) and structural operations (longer-term credit operations and securities purchases).
- Credit operations will return to center stage and will continue to be offered as fixed rate tenders with full allotment.

But what about the natural rate of interest (r^*), that has fallen in recent decades and is estimated now to be close to zero, albeit more recent estimates indicate it might have increased somewhat.

Without a re-rise in the natural rate, we seem to be confined to resort to unconventional monetary policy in a renewed form. If the natural rate r^* were to be endogenous and if we could engineer a re-rise, we could return to the less distortionary conventional monetary toolbox while contributing to enhance welfare.

So, how could we increase r^* and which structural policy interventions are necessary? From my point of view, there are three main routes which need to be considered:

- first, an increase in total factor productivity, e.g. via digitalization, artificial intelligence and climate change mitigation policies;
- second, an increase of the labor market participation rate; and
- third, capital flows from the Global North to the Global South.

My staff is currently preparing a paper on these deliberations, to be released in the next weeks, and I will have the honor to give a lecture on this topic at the University of Cambridge tomorrow. Now, let me turn to the last topic of my speech today, which is also another project my staff is currently looking at in more detail and where a lot of optimism is required:

3. Fostering the capital markets union in the EU

As we have seen, the growth outlook in Europe is not especially bright. Even more, looking at productivity developments, we are seeing that Europe is increasingly lagging behind, for instance when compared to the US. Also, taking a longer run view:

Long-run productivity growth and innovation – as e.g. measured by patents or expenditure on R&D – are lagging behind on the continent as compared to the US but also – even if not as starkly – in contrast to the UK.

A major reason for this might be the fact that the development of the capital market is substantially lagging behind in Europe:

- Market capitalization is significantly lower in the EU than in the US and the UK, and fragmentation is excessive.
 - In fact, market capitalization in Europe is so fragmented that it already is burdensome just to quantify it at an aggregate level. Further, the market for corporate bonds is only a fraction of that in Anglo-Saxon economies, and firms in many European economies are excessively dependent on banks.
 - The low market capitalization in the EU also hinges on a limited pool of private capital, such as large-scale investment and pension funds that might be interested in investing in risk capital markets.
- Even more problematic for the growth potential of the European economy is the lack of venture capital. Currently, even in the best-performing European economies, venture capital as a share of GDP only corresponds to half of the level available in the US, and as an aggregate, the euro area vastly underperforms compared to the US and also the UK in this regard. As an example, the UK has developed a very successful model for growth capital – the BGF – which is supporting innovative growth companies with patient capital.

We know from empirical evidence that deep capital markets are conducive to growth in countries with sound democratic institutions like the EU. This calls for more action to deepen capital markets. Importantly, it should be noted that deep capital markets can also help in the provision of the urgently needed capital to finance the green and the digital transition as well as increased defense spending needs. Estimates for additional financing needs amount to approximately EUR 1 trillion each year.

Another aspect in this regard – and this is particularly interesting here in the UK – is that Brexit has substantially changed the nature of European financial markets. This bears some risks, most prominently that of fraying capital markets and increased mark-ups due to the complexity and opaqueness of the European market. Even more, the UK took some of the largest venture capital funds of the European Union with it when it left.

To conclude, I repeat my call for fostering the capital markets union in the EU. In this respect, I highly welcome the report by a committee of experts chaired by Christian Noyer on the proposals to revitalize the capital markets union, which was published on April 25, 2024. The report stresses the urgency for action in order to close the widening of the economic gap vis-à-vis the US and focuses on four transformative recommendations: (1) developing European long-term savings products, (2) revitalizing the securitization market, (3) moving toward an integrated supervision for capital market activities, and (4) addressing the fragmentation of settlement systems.

It would support the additional financing needs, help make Europe more resilient in the face of asymmetric shocks and enable innovative growth companies to remain in the EU. However, I am afraid that just introducing a capital markets union won't be enough. Successful capital markets also do need capitalists.

So, the challenges we are facing are high. But, as quoted at the beginning of my speech: "I am an optimist. It does not seem too much use being anything else." Let me stop here and wish you all a pleasant and enjoyable evening.