Ignazio Visco: The euro area – uncertainty and growth

Lunch address by Mr Ignazio Visco, Governor of the Bank of Italy, at the OMFIF – 7th Main Meeting in Europe "The euro area and the world economy: overcoming challenges, spurring growth", Rome, 22–23 September 2016.

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Uncertainty is the hallmark of current global conditions. Conflicts in the Middle East, tensions in the Far East, and political strife in a number of emerging and low income countries are long-standing issues, whose resolution appears anything but imminent. Concerns over a possible hard landing in China have eased but there is no guarantee of a smooth transition to a more balanced growth model. Uncertainty is also being fuelled by developments in advanced countries, such as the acrimonious run-up to presidential elections in the US and the fall-out from the recent British referendum on EU membership. Difficulties in interpreting the economic outlook in the US are hampering the Federal Reserve's efforts to provide clear forward guidance.

In the euro area uncertainty is being heightened by specific factors. Difficulties in managing exceptional migration flows are causing deep political rifts among member states. Together with economic hardship, they have fuelled the rise of populist movements, which are espousing nationalist ideologies and campaigning against the European project and the single currency. While the vote for Brexit is casting a shadow over the future of the EU, a sequence of electoral cycles and popular consultations is narrowing the focus of politics to mostly domestic and short-term issues. The economic outlook remains dominated by very low inflation and the persistent risk of a de-anchoring of inflation expectations. The policy mix is suboptimal: there is no common fiscal policy and many countries lack sufficient room for manoeuvre. Bank profitability remains weak and several intermediaries may need to strengthen their balance sheets against the background of subdued economic prospects and the ongoing process of regulatory reform.

The Governing Council of the ECB has acted boldly to encourage a return to price stability. Official interest rates have been reduced repeatedly, bringing the deposit facility rate to negative levels. New longer-term refinancing operations have been introduced, with conditions rewarding banks that provide more credit to the economy. The Asset Purchase Programme has been progressively expanded. At the start of 2015 its scope was broadened to include public sector securities; in December its duration was extended to at least the end of the first quarter of 2017; last March, the amount of monthly purchases was increased; as of June, the ECB began making purchases of investment-grade bonds issued by non-bank corporations.

Contrary to what is sometimes argued by looking at the current outlook for inflation and growth, our action has been effective. In the absence of the measures adopted, economic conditions would have been much worse, possibly leading to a deflationary spiral. Credit supply conditions, which were particularly tight in 2011–12, have gradually eased. The cost of credit to the economy has fallen and financial fragmentation in the euro area has lessened; the weak credit dynamics that we are still observing in the area are mainly due to subdued demand. Our measures have fostered a decline in yields and bolstered the prices of a wide range of financial assets, with a positive impact on consumption, through wealth effects, and on investment, through the fall in the cost of capital. They have buoyed business and household confidence. According to our estimates, without the wide range of monetary policy measures introduced between mid-2014 and the first part of this year, annual inflation and GDP growth would be more than half a percentage point lower in the euro area in the three years 2015–17. For Italy, the estimated effects are more pronounced.

The highly expansionary monetary policy stance is the result of well thought out decisions and is a response to the weakness of the economy and the risk of deflation. Low inflation is

undoubtedly in part a global phenomenon. It reflects developments in oil prices; deflationary pressures from the Chinese economy; and possibly also technological change. But it also depends on domestic developments that should not be underestimated. Domestic factors operate both via expectations and via economic activity, and in both respects conditions in the euro area differ from those in other main advanced economies. Since the end of 2014, the risk of a de-anchoring has increased particularly in the euro area, where expectations have reached lower levels than in other advanced economies. There is also evidence of a stronger link between low inflation and economic slack; in Italy, France and Spain nominal wages became more reactive to unemployment after the crisis.

We are, of course, conscious of the potential for negative collateral effects from a long period of very low interest rates. In the euro area as a whole there is, at present, no evidence of risks to financial stability related to an excessive increase in the prices of shares, corporate bonds or houses. Growth in lending relative to the cyclical position of the economy is moderate. Risks that may arise in specific sectors can be addressed with carefully targeted macroprudential instruments, as has already happened in some countries, without interfering with the monetary policy stance. Nominal rates that or low or negative for too long may hurt the profitability of some institutions, but a less accommodative monetary policy in the current circumstances would be harmful to everyone.

Strengthening the economy is key to ensuring a return to price stability as well as to mitigating the risks to financial stability. In the current cyclical conditions the main risks to financial stability, the profitability of banks and firms, and even to household income continue to stem from the uncertain macroeconomic outlook and the persistence of exceptionally low inflation. We will continue to monitor economic and financial market developments very closely and, if warranted, will act again by using all the instruments available within our mandate. Our purchase programme is intended to run until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation objective. We have tasked the relevant committees to evaluate the options for ensuring its smooth implementation.

But monetary policy cannot pursue a return to price stability and a more sustained growth rate in isolation. It must be accompanied by fiscal policies that are consistent with cyclical conditions and by reforms designed to achieve a permanent return to higher rates of growth potential and job creation. The fear of a continuation of very modest demographic and productivity growth is the likely real cause of very low real interest rates.

At the peak of the crisis the aggregate fiscal stance in the euro area was pro-cyclical. Without a lender of last resort, shocks to the perception of fiscal sustainability can be (and were) greatly amplified. To rein in escalating risk premia, many euro-area member states had no choice but to adopt pro-cyclical fiscal policies to regain market confidence and avoid financial disaster. The need for fiscal consolidation originated from insufficient prudence before the crisis, but was amplified by the generalized restrictive interpretation of European fiscal rules. Though the benefits of the averted financial meltdown proved greater, the macroeconomic costs of this strategy have nonetheless been significant and have not been offset by instruments for a common countercyclical response to symmetric as well as asymmetric shocks.

The margins of flexibility built into the rules are now being exploited. The 2015 communication by the Commission on how to make the best use of the flexibility within the existing rules of the Stability and Growth Pact was a step in the right direction. Fiscal stimulus could be enhanced if countries enjoying more fiscal space were to exploit it in a way that boosted aggregate demand domestically and in the area as a whole. Others could contribute by tilting the composition of their budgets towards the items most friendly to growth, first and foremost investment in material and immaterial infrastructures. But ultimately only a common budget, achieved by further transfers of national sovereignty and an adequate strengthening of the democratic legitimacy of supranational institutions, would

make it possible to implement policies consistent with the cyclical conditions in individual economies and in the euro area overall, promptly and with no doubts as to their admissibility.

Important structural reforms have been adopted in several euro-area countries. These efforts must continue. Their benefits are beginning to be felt, but it will take time to exploit their full potential. Each country has its own problems and solutions are difficult to standardize. Reforms imply short-term costs, both economic and political, and we should guard against the risk of unintentionally introducing obstacles. For instance, excluding some countries from advances in fiscal and political union until they have achieved sufficient convergence would actually make their reform efforts more difficult. Introducing a divide within the euro area can hardly be seen as a step towards the "deepening of EMU".

The resilience of euro-area banks has significantly improved in recent years, as also shown by the results of the recent stress test. The euro-area banks included in the EBA sample entered the test with an average CET1 capital ratio of 13 per cent, a marked improvement on the 11.2 per cent reported in the 2014 EU-wide stress test. Despite the more stringent methodology and tougher adverse scenario, the final average CET1 ratio was higher than in 2014. As for Italian banks the stress test showed that most institutions have robust fundamentals, while there are a few, clearly identified cases of serious but manageable weakness, which must be tackled and resolved, as required by bank supervisors.

In the current low-growth, low-rates, high-competition environment, the main weakness of banks in the euro area is low current and expected profitability. Indeed, concerns about profitability are exerting downward pressure on banks' equity prices, which have fallen by around one fourth on average since the beginning of this year. While the cyclical recovery is starting to provide some relief, further bold action is needed to increase profitability, so as to generate sufficient internal capital and an adequate return for shareholders and investors. Business models should be profoundly reworked and updated, to take full advantage of the developments in technology, reduce costs, optimise their composition, and diversify revenue sources as much as possible. All banks need to move in this direction, but the weakest institutions need to take more rapid and aggressive action. A consolidation process would be beneficial, as this could facilitate the rationalization of banks' organization and branch networks, with a view to serving the evolving financial needs of firms and households more effectively. We should all facilitate this process.

As supervisors and regulators, we are well aware of the negative effects of lingering uncertainty over the finalisation of the regulatory reform process started some years ago. We remain committed to dispelling it as soon as possible. The Group of Central Bank Governors and Heads of Supervision (GHOS) recently confirmed that progress is being made towards the finalisation – by the end of the year – of post-crisis regulatory reforms aimed at reducing excessive variability in risk-weighted assets. The Group, moreover, reaffirmed that the Basel Committee should not significantly increase overall capital requirements.

Especially in some euro-area countries the high stock of NPLs represents an additional drag on banks' profitability. In Italy, where this stock is particularly high, the issue is being addressed effectively. There are signs that the NPL market is developing thanks to the comprehensive strategy pursued by Italian authorities through a number of initiatives (improvement of recovery procedures, the government guarantee on the securitization of bad loans, the establishment of the Atlante funds) and the pressure exerted by supervisors (the most recent examples being the detailed survey on bad loans launched by the Bank of Italy and the NPL management guidance issued for consultation by the ECB). The expected increase in sales, together with better in-house management and asset recovery, will help resolve the NPL issue. It will take some time, but the process has started and will soon bear fruit.

Speeding up the recovery and enhancing potential growth requires greater private and public investment. Concerning public investment, by exploiting the available fiscal space while working within its constraints, national budgets can contribute to these goals by revising the

composition of expenditures. At the European level, the Juncker Investment Plan has started to deliver concrete results; its extension and enhancement, along the lines put forward by the European Commission, would be a further step in the right direction. To foster firms' investment plans and their financing we need to dispel institutional and political uncertainty. Significant progress on the capital markets union would be an important move in this direction. It would give enterprises access to finance on better terms. But we should not fool ourselves into believing that this is simply a matter of changing a few regulations at the national level. A genuine capital markets union requires common company and bankruptcy laws, implying far-reaching changes in national legal systems. It also requires a common "safe asset" which would prevent the fragmentation of markets along national lines during times of crises. All in all, a true capital market union does, in fact, require more than very gradual progress towards a genuine Economic and Monetary Union.

In conclusion, I started these remarks by emphasising the critical role that uncertainty, in its various dimensions – political, institutional, economic – is playing in today's global economic landscape. For the euro area, uncertainty poses a specific problem in so far as it could undermine the process of European integration. Uncertainty about the future of the EU and EMU is one of the factors holding back investment and preventing a stronger recovery in the euro area. Reducing uncertainty is therefore one of the most pressing challenges for European policymakers. It not only requires adequate institutions and policy tools but above all true leadership capable of restoring a common sense of purpose and defining a clear vision for the future of the European project. This is the only possible response to rising populism and the risks it poses to the future well-being of European citizens. We know that there are many short-term challenges. But we must continue to emphasise the need for a longer-term perspective and we remain convinced that the sharing of views on occasions such as these can help build this vision. It is this conviction that has animated the meeting now drawing to a close.