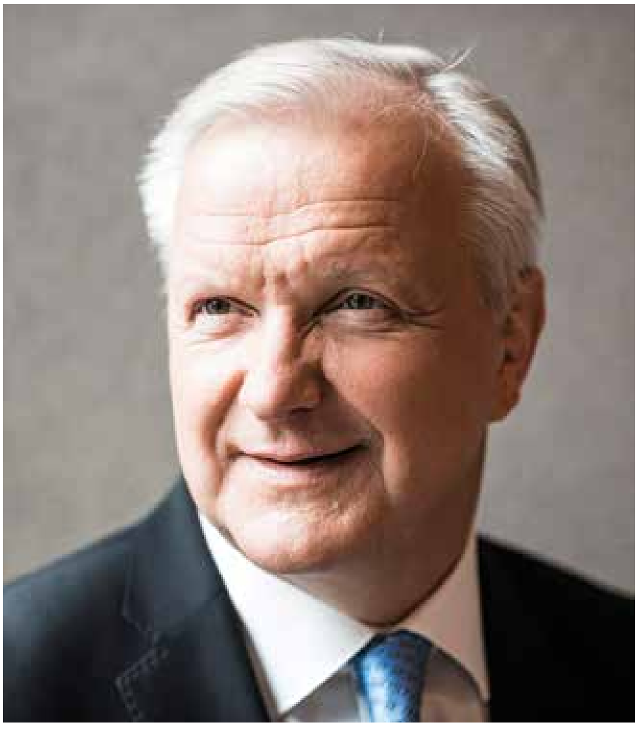
Q&A

Olli Rehn

Governor,
Bank of Finland

Growth and Investment Union to boost Europe's economic revival



HOW MAY SUSTAINABLE GROWTH AND ECONOMIC CONVERGENCE BE FURTHER DEVELOPED IN THE EU? WHAT ARE THE PRIORITIES FOR THE NEXT FIVE YEARS IN THIS AREA?

Apart from managing immigration better and reinforcing external and internal security, our key policy challenge in the coming years is to boost an economic and industrial revival of Europe. The prolonged presence of pervasive uncertainty in the world economy, especially the expanded trade war, underlines the importance to concentrate on Europe's economic and industrial revival.

It should put focus on enhanced productivity through economic reforms and through a revitalisation of the Single Market. Moreover, it should strive for an ever stronger public and private investment in innovation and research. Furthermore, Europe's economic revival needs to be combined with the greatest challenge of our generation: tackling and mitigating climate change. It calls for a consistent strategy from the EU on how to pursue economic and ecological transformation of our societies and enterprises, from fossil fuels to renewable energy, from the production of waste to circular economy.

The single market needs an additional boost and deeper integration. A well-functioning financial system is fundamental for growth. The completion of the banking union and enhanced efforts towards the capital markets union are essential building blocks of both the integrated single market and a more resilient monetary union.

Economic reforms need to be substantially stepped up in euro area countries to increase resilience, reduce unemployment in a lasting way and boost productivity. The power of monetary policy is limited and can become overburdened without the support of other policy areas. Growth requires more investment, research and innovation.

For sustainable growth sufficient public sector contribution is needed. It is important to invest in public infrastructure, including digital infrastructure and boost environmental investments. Sufficient public investment can also boost private R&D.

We should also continue to work for a Europe that promotes growth beyond its own borders through free-trade agreements, despite the current headwinds; for a Europe that combines entrepreneurial drive and a stability culture; and for a Europe that guarantees civil rights and social justice in the digital age.

These are the concrete, functionalist goals for sustainable growth and job creation – and fundamentally for human development – that do really matter to our citizens in Europe, which should always be our yardstick. They should be supported by rock-solid financial stability that can be enabled by completing the banking union.

TO WHAT EXTENT IS A FURTHER CUT IN INTEREST RATES LIKELY TO PRODUCE HIGHER INFLATION AND A REBOUND OF ACTIVITY IN THE EURO AREA? HOW TO ADDRESS THE POSSIBLE SIDE EFFECTS?

In policy-making, it is usually better to be safe than sorry. This goes particularly for monetary policy. As a consequence of the recent slowdown, central banks have put monetary policy normalisation on hold and instead started to prepare an accommodative policy stance if needed. This holds true for the ECB as well.

The ECB Governing Council is determined to act in case of adverse contingencies and also stands ready to adjust all of its instruments, as appropriate, to ensure that inflation continues to move towards the Governing Council's inflation aim in a sustained manner.

The ECB has a wide range of monetary policy instruments in its toolbox. We can push the policy rate into negative territory, employ forward guidance on the future policy path, purchase a significant stock of assets from a variety of asset classes to lower yields and offer banks targeted loans to ease their funding costs. These measures work as a package, with significant complementarities across the different instruments.

Lower rates, or rather the total package of unconventional monetary policy measures, have improved financing conditions and enhanced the macroeconomic performance of the euro area. Negative rates together with our forward guidance of future policy rates have pushed down the short-end segment of the yield curve that determines the pricing of loans to non-financial corporations. It follows that the control of this segment of the curve directly influences the level of lending rates.

At the same time, there may be negative side effects. The Governing Council will continue to assess the case for mitigating measures, which is especially relevant as the time period of negative rates has been extended and if there were further rate cuts.

WHAT ARE THE REASONS FOR THE REDUCTION OF CROSS-BORDER CAPITAL FLOWS IN THE EUROZONE SINCE THE SOVEREIGN DEBT CRISIS? WHY HAVE EU INITIATIVES TO FURTHER INTEGRATE FINANCIAL MARKETS AND DEVELOP CROSS-BORDER INVESTMENT NOT HAD MORE EFFECT IN THIS RESPECT?

Despite the positive financial integration developments after the adoption of the euro, an unfortunate fact is that we are still missing a pan-European capital market. Pre-crisis financial integration turned out to be unsustainable and there was serious fragmentation in several market segments during and after the global financial crisis.

The post-crisis reintegration trend has shown some positive signs in terms of prices, but not in quantities. In banking, there has been a reduction in the cross-country dispersion of funding costs and lending rates, but cross-border retail lending has remained stubbornly weak.

The subdued development of cross-border capital flows is partly explained by the slow recovery of the euro area economy after the financial crisis. The crisis had a severe and long-lasting drag on investments in particular. Financial institutions have had to focus on safeguarding profitability and solvency under challenging conditions and less on increasing cross-border activities.

However, the key underlying factor for the weak development is remaining shortcomings in the EMU financial architecture. While we have made good progress in strengthening the regulatory and supervisory framework and enhancing the institutional setup, the EMU financial architecture is still not sufficiently conducive to cross-border integration and there remain incentives for ring-fencing and home bias.

The EU initiatives to boost investment have been providing easier access to EU funding, with the Juncker Plan having triggered some EUR 400 billion of investments and the new InvestEU Programme promising to build on its success in the years to come. However, we need more private financial risk sharing to support innovation and efficient allocation of capital, and to improve macroeconomic stabilisation.

HOW TO SUSTAINABLY IMPROVE CAPITAL ALLOCATION ACROSS THE EU?

The crucial issue is the completion of the EMU financial architecture. While a banking union is efficient in sharing demand shocks, a capital markets union, via increasing cross-ownership, is necessary to help absorb supply shocks.

There has recently been good progress in taking CMU-related EU legislation forward but significant further steps are needed to create a well-functioning CMU. Harmonising insolvency rules across jurisdictions in the EU would be a major step forward. However, it is difficult and will require long-term efforts. The next steps could focus on harmonising certain basic concepts, such as preconditions for triggering an insolvency procedure, definition of insolvency, and creditor hierarchy.

Overall, progress in establishing the CMU has been slow and there is a need to reinvigorate the project. With this in mind, I think it would be useful to reassess the narrative we attach to the CMU. A new concept – "Growth and Investment Union" for example – might put a more positive spin on the project. ●