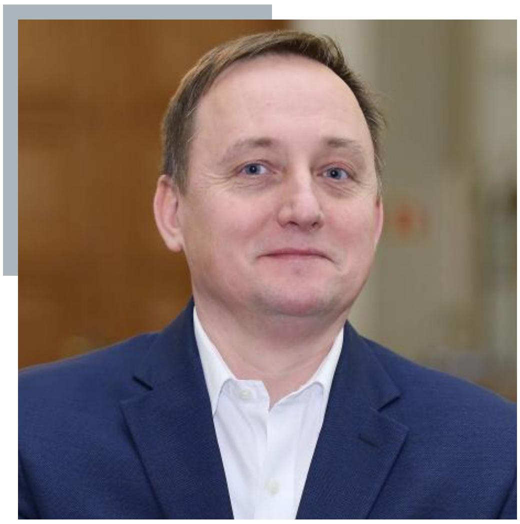

MĀRTIŅŠ KAZĀKS
Governor,
Bank of Latvia

We have brought water to the horse, but we cannot make the horse drink

Since the global financial crisis and, in particular, during the Covid-19 pandemic major central banks have provided ample monetary policy accommodation. By several measures, the ECB has provided more support than the Fed. Since 2017 the balance sheet of the ECB in percent of GDP has substantially outgrown that of the Fed. The Fed never resorted to negative rates. Euro area nominal and real interest rates are near their historical lows. Targeted long-term refinancing operations provide very favorable financing conditions to banks that pass this funding to their lending portfolio. Tiering shields bank profitability by reducing the cost of holding excess reserves when banks cannot pass this cost to their clients.

Unless policy rates go beyond their reversal rate levels, which they have not, zero or negative interest rates are supportive to investment. Ultra-low interest rates should encourage investment as they expand the universe of profitable projects, turning some of those that had negative net present value into profitable endeavors. Of course, some of the recent investment weakness is cyclical, but it is not the whole story. Structural factors must play a role there, too. Let me point to three such factors.

First, the EU common market is still in many ways fragmented, particularly in services. Take the digital domain. Different national requirements still act as virtual borders. Building scale quickly to harness network effects is crucial and the national markets of even the largest EU countries are too small for that. It is somewhat ironic that cross border retail transactions in the EU are mostly enabled by payment solutions developed outside the EU. We need to complete the single digital market and create a retail payment solution based in the EU. The latter should ideally be a private sector solution. A digital euro could support it.

Second, financial markets in the EU are dominated by banks. Underdeveloped capital markets, especially in smaller jurisdictions, mean fewer sources of financing for investment and innovation, less diverse risk taking and a limited set of business strategies, especially if the market is dominated by just a few big lenders. Moreover, the profitability of the European banks has been weak and that is only partly a cyclical issue.

Despite the efforts to strengthen the European banking union, banks largely remain domestically oriented, with a strong bank-sovereign nexus. As a result, they are not able to reap the full benefits of European integration. Extra efforts are needed to move towards a genuine European banking union. At the same time, banks cannot and should not intermediate all risks. A more diverse financial market ecosystem is a must. Deep and well-functioning capital markets are not a luxury. Without a dynamic capital market, Europe risks more under-investment, a less vibrant economy and lost opportunities for its citizens.

Third, frontloaded and investment-geared fiscal support is needed both at the national and the EU level. The euro area non-financial investment has not yet fully recovered from the austerity of 2012-15. In view of worsening corporate balance sheets, low cost of sovereign financing makes it possible for the public sector to fill in the most critical private sector investment shortfalls. True, national fiscal policies have been expansionary during the Covid-19 crisis, but little of it has supported investment. While the USD 1.9 trillion Biden package could risk being too concentrated in time and overheat segments of the US economy, it is projected to close the output gap already at the turn of the year. The EUR 672.5 billion EU Resilience and Recovery Fund is a very welcome step in the right direction but is stretched over five years, only to visibly kick in towards the end of the year and will not close the negative output gap neither this year nor next. With single monetary policy, a larger common fiscal capacity would yield a more effective policy mix. If we let long-term investment dwindle, productivity and income growth will be anemic.

To summarize, in addition to monetary policy, we need two more games in town - structural reforms and bolder fiscal policy. Paraphrasing an old saying, central banks can make sure that there is plenty of water in the river, we can even bring water to the horse, but we cannot make the horse drink.