



Q&A

GABRIEL MAKHLOUF

Governor – Central Bank of Ireland and
Member of the Governing Council – ECB

Being ambitious for Europe: focusing on the change that matters

Europe has abundant savings, yet a significant proportion continues to be invested outside of the EU. What monetary, macroeconomic and structural conditions are needed to ensure that European savings are better mobilised to finance European companies and strategic priorities?

It is the case Europe has abundant savings. The fact that a significant proportion of those savings is invested outside of the EU reflects the fact that capital expects higher returns in non-EU markets. So the question is *why* European returns have been lower and what can be done about it. Fundamentally, it's about the performance of the real economy. And if European growth remains relatively weak, it limits the upside for other changes to attract and retain capital, which is the message at the heart of the *Draghi* and *Letta* reports. We must deliver macroeconomic reforms to boost productivity.

Of course, these reforms need to build on the fundamentals. Successful economies need a stable and sustainable macroeconomic framework, sound monetary policy that delivers stable and predictable prices, a prudent fiscal policy and debt that's under control. Successful economies are also characterised by well-regulated financial systems and well-functioning markets. We should hold on to these fundamental truths while we contemplate reforms to support improvements in European productivity.

And in my view we should have a steely focus on the *biggest* picture – putting aside the myriad of distractions that can occupy our time – and look to complete the Single Market. The fact that barriers exist is beyond argument. Its original designers would be shocked to see – thirty years on – the barriers that exist, particularly in trade in services. Moreover, a barrier-free Single Market would make a step change in enabling a deepening of Europe's capital markets, enhancing investment returns, and facilitating investment in innovation and increases in productivity.

Real interest rates clearly matter, and not just at the margin. For institutional investors, the real yield on European fixed income also shapes portfolio allocation in a fundamental way. When real yields on European bonds are deeply negative, as they were for much of the last decade, the incentive to diversify toward dollar-denominated assets is powerful. Conversely, a more normalised real rate environment – which we now have – should in principle support a reallocation back toward European assets, provided the growth story and market infrastructure are also in place. The interaction is important: real rates set the price of waiting, but it is growth expectations that determine what you are waiting for. Without the latter, even attractive real yields may not be sufficient to anchor European savings at home.

And of course less than optimal market depth is both a cause and a consequence of EU savings being invested outside of the EU. Liquidity attracts liquidity; large institutional investors are reluctant to commit to markets they cannot exit easily, which keeps volumes low, which keeps liquidity thin. Breaking this equilibrium requires a critical mass of new issuance – especially for a European safe asset – and a consolidation of market infrastructure.

In summary, I see it as three pieces of an archway. On one side, market depth and liquidity are necessary but not sufficient in isolation. On the other, real interest rates set the price signals that allocate savings across asset classes and geographies at the margin. But growth prospects are the fundamental attractor. You can fix the plumbing and calibrate the price signals, but if the growth story is not there, sophisticated capital will continue to find its way out.

Over the past year, several EU initiatives have been launched to revive the SIU in order to strengthen innovation, investment and Europe's financial markets. Are these initiatives adequate to achieve this ambition? What are the main remaining

regulatory, legal or political obstacles still preventing the development of EU capital markets?

I support the European Commission's objective of deepening European capital markets. The SIU is an ambitious initiative with significant potential to enhance European capital markets. I welcome in particular the focus of the package on reducing fragmentation within markets, simplifying the rulebook, supporting innovation and improving supervisory efficiencies and convergence.

Our recently published consumer research on Retail Investor Participation in Ireland¹ noted that retail investment in capital markets can deliver two important outcomes: providing opportunities for households to secure their long-term financial well-being and providing a critical source of funding for growing businesses, enhancing overall productivity across the broader economy. Channeling such capital could greatly aid the enhanced competitiveness of the EU.

And it's important to acknowledge that we've seen substantial progress on many of the legislative proposals to deepen Europe's capital markets, including in relation to the Retail Investment Strategy, the publication of the recommendation for an EU Savings and Investments Accounts and the proposals for extensive reforms under the Market Integration and Supervision Package.

But, as I said above, I'm not sure a focus on the SIU alone will make the difference to the productivity that Europe has the potential to deliver and that we all want to see. For example, the debate on who supervises what elements of capital markets should not distract from higher priority areas. The fact is that Europe already has a robust regulatory system and high-quality regulators and supervisors across its financial centres. I accept that supervision and convergence need to continue to improve but when I look at US capital markets, it is not the centrality of their (many) supervisors and financial centres that stands out. Rather it includes deep and liquid markets underpinned by a large supply of a globally systemic safe asset and a high level of retail investor participation, including deep pension pools. These are among the elements I believe Europe should prioritise.

In fact if we want to continue deepening and developing the SIU, I suggest we should focus on four priorities:

First, and foremost, remove the barriers in the Single Market, both in trade in goods but particularly in services. If the barriers are removed, the second, third and fourth priorities below are likely to be easier to deliver. If the barriers are left as they are, we risk wasting a lot of energy on them.

Second, mobilise our internal capital through greater retail investment and participation. This should include learning from others, not least other Member States, and looking seriously at reforming pension regimes. Apart from deepening capital markets, the latter would also support the challenges of demographic change and fiscal sustainability.

Third, increase the attractiveness of Europe's market to external capital and remove barriers to the flow of capital internally. A European safe asset to anchor institutional capital would be a significant step forward, and an important counter to European savings and capital risk being drawn towards dollar-denominated safe assets.

Fourth, ensure we are adapting to the economy of the future, which inevitably means much greater development and adoption of and investment in technology, as well as continuing to focus on the transition to a net zero world.

Realising Europe's economic potential is a function of ambition. And for me that ambition tells me we should focus on the change that matters.

1. https://www.centralbank.ie/docs/default-source/publications/consumer-protection-research/retail-investor-participation-in-ireland-consumer-research-and-analysis.pdf?sfvrsn=78bb6fa_11