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The European economic policy response to a scenario of lower growth and inflation

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Distinguished rector, honourable mayor, academic authorities, dear students, ladies and gentlemen. Let me begin by extending my particular thanks to Professor Velarde for his kind invitation to participate in the closure of the 2019 La Granda summer courses.

It is an honour for me to be here in this building, whose doors are open to all those interested in discussing and delving into the essential issues ever-present in these courses.

Today I would like to share some thoughts with you on the complex economic outlook the European Union (EU) and, in particular, the countries comprising the euro area currently face. This is at a time when free trade, the bedrock of the European project and an essential source of the improvements in economic well-being in recent decades, is subject to continuous threats.

I shall first describe the latest economic developments and the main challenges ahead. Then I shall analyse what, in my opinion, the economic policy responses to these challenges should be.

The return of protectionism

Only two years ago the global environment was a favourable one. It was marked by a synchronised expansion of the emerging and advanced economies, reflected in the highly robust world trade performance.

But the international economic setting turned more unfavourable in 2018. This situation has run into 2019 to date, with a slowdown in growth (acutely so in manufacturing) and, in particular, in trade.

Indeed, the latest information shows that economic activity is expected to have continued worsening in recent months. This is evident in the manufacturing Purchasing Managers' Index (PMI), which has since the start of the year stood below 50, a level indicative of a contraction in activity. The reduction in the last few months in the global service sector PMI, which had held firmer to date, in expansionary territory, suggests an increased risk of a greater slowdown in global activity.

This downturn in activity has also been accompanied by more marked divergences across geographical areas.

Among the advanced economies, activity has remained relatively robust in the United States, underpinned by the fiscal expansion and the soundness of private demand. However, the gradual tailing off of the effects on activity of tax cuts, the signs of a global slowdown and the absence of clear inflationary signals have already prompted a shift in the Federal Reserve's monetary policy. This has taken the form of the announced conclusion of the balance sheet reduction process as from September and, last July, the first interest rate cut since 2008. Moreover, the financial markets anticipate further cuts in rates in the rest of 2019 and in 2020.

In other geographical areas, GDP growth has been increasingly weak. This has been the case in the European economy, to which I will refer later.

Among the emerging economies, China remains beset by the difficulties of managing in an orderly fashion its much-needed economic rebalancing and deleveraging process, despite the significant stimulus measures approved this year by its authorities. China is important for the global economy: it accounts for almost one-fifth of global GDP, in purchasing power parity terms, and it has contributed almost 1 percentage point to annual average global GDP growth since 2005. And clearly, an additional slowdown in its growth rate would have major global implications, through the trade and financial channels, and through the prices of commodities, for many of which it is the main source of demand.[1]

Some of the emerging economies with the greatest vulnerabilities, such as Argentina and Turkey, have been particularly affected by the financial tensions and continue to face significant challenges. In Argentina especially the situation has worsened considerably in recent weeks, against a backdrop of great political uncertainty.

As mentioned, the slowdown in activity has been particularly acute as regards trade. Various factors are behind this downturn. They include most notably the impact of trade conflicts, especially between the United States and China, and the uncertainty associated with Brexit.

The trade conflict has unfolded in various phases. In spring 2018, higher US tariffs on different products (mainly imports from China) came into force, with the countries affected retaliating accordingly. Moreover, the US government threatened to extend and step up tariff rises (including, in particular, those on vehicle imports, a sizeable portion of the bilateral trade with Europe).

The second half of 2018 saw some positive events: the signing by the United States, Mexico and Canada of the pact replacing the North American Free Trade Agreement; the opening of negotiations for a US/EU agreement; and the temporary truce called between the United States and China to settle their differences.

More recently, however, in May and June this year, there was a fresh escalation in trade tensions between China and the United States. US tariffs on $200 billion worth of Chinese product imports were raised from 10% to 25%, and the response by the Chinese authorities was to raise tariffs on US imports.

At the G20 summit in Osaka in late June, the two countries reached an agreement to reinitiate trade negotiations. Yet despite this, and the fact that the United States subsequently announced the suspension of certain restrictions on US companies selling technological equipment to specific Chinese firms, August saw a new episode in the escalation of tensions in the trade war between the two countries. Moreover, the United States, which has accused the Chinese authorities of manipulating the exchange rate, has postponed until November its decision on potential tariff increases on cars and their components, a measure that would mainly harm the EU and Japan.

[1] See Box 1.1, "The global impact of a hypothetical economic slowdown in China", in the *Annual Report 2018,* Banco de España, and Box 2, "Economic policy room for manoeuvre in China", in the "Quarterly report on the Spanish economy", *Economic Bulletin,* 2/2019, Banco de España.

The economic literature fairly unanimously considers that trade openness in the world economy in recent decades has been fundamental for global growth and social well-being.[2]

Against this background, the proliferation of protectionist measures is one of the greatest threats to the world economy. Along with their direct repercussions on global activity, such measures generate additional adverse effects through their impact on global confidence. And these effects are so far proving significant. Accordingly, any future proliferation of additional protectionist actions, further undermining confidence and affecting financial conditions (and, therefore, business investment), might ultimately impact global GDP severely.[3]

Turning to Brexit, it is over three years since the UK referendum on EU withdrawal. Doubts persist over how the exit process will be resolved, and Brexit remains a primary source of uncertainty for global economic activity and, especially, for the rest of the EU. After the latest developments, including the new prime minister's decision to suspend parliament until mid-October, the markets now consider a hard Brexit to be more likely.

On the simulations available, a Brexit with a trade agreement would have a relatively limited effect. But the adverse consequences of a no-deal Brexit would be significant, especially for the UK economy.[4] Against this background of uncertainty, UK GDP has already posted negative growth in the second quarter of this year.

The economic situation in the euro area: economic slowdown and low inflation

The more open European and East Asian economies have been those most affected by these international trade developments. However, the adverse effects have spread to many other economies through global value chains.

The euro area, in particular, has slowed significantly since early 2018. This is mainly due to the strong easing in its exports. As a result, average GDP last year grew by 1.8%, 0.7 pp down on 2017, and year-on-year growth in late 2018 and early 2019 fell to around 1%.

The euro area's high degree of openness (its trade flows with third countries account for 50% of the area's GDP, compared with 38% for China and 28% for the United States) means it is particularly sensitive to external shocks and to the slowdown in world trade. Moreover, the above-mentioned uncertainty over Brexit has prompted a contraction in exports to the UK economy in recent years.

Also contributing to the slowdown in growth in the euro area have been specific circumstances in certain sectors and countries. I refer in particular to the difficulties the automobile industry is undergoing in adapting to the new environmental regulations, to new production technologies and to protectionist threats.

[2] For a summary of this literature, see, for example, A. Estrada, J. Martínez-Martín and F. Viani (2018), "Una revisión de la literatura económica sobre los efectos de la globalización en el crecimiento y la distribución de la renta", Notas Económicas, *Boletín Económico,* 2/2018, Banco de España.

[3] See Box 1, "An estimation of the impact of the recent protectionist measures", in the "Quarterly report on the Spanish economy", *Economic Bulletin,* 2/2018, Banco de España; Box 1, "Implications of rising trade tensions for the global economy", in *Economic Bulletin,* 3/2018, ECB; and International Monetary Fund (2018), "Scenario Box 1. Global Trade Tensions", World Economic Outlook: Challenges to Steady Growth, October, pp. 33-35.

[4] See IMF (2018), "Euro Area Policies: Selected Issues", and J. L. Vega (coord.) (2019), "Brexit: current situation and outlook", Occasional Papers, no 1905, Banco de España.

Among the European countries, Germany's industry and export-based growth model has been greatly affected by external developments. But Italy has been the most beleaguered, given its weak GDP growth, the result of the uncertainty over the course of its economic policy.

Indeed, the latest available information generally points to a slowdown in the growth rate across the euro area, concentrated especially in the industrial sectors. Moreover, the weakness of the external sector is also spreading to investment. That means the sluggishness of external demand, heightened political uncertainty in some countries and the easing in corporate profits are already bearing down on firms' spending plans. Furthermore, the leading indicators of euro area exports show no signs of having touched bottom.

The flash estimate for euro area GDP in the second quarter shows quarter-on-quarter growth of 0.2% (compared with 0.4% in the first quarter), with negative growth of 0.1% in Germany and stagnation in Italy. Some countries, such as France and Spain, which have remained more buoyant in this period, have also posted slowdowns – to 0.3% and 0.5%, respectively – in the second quarter of the year. [5]

In contrast, the most favourable factor since the onset of the economic recovery in the euro area has been the improvement in the labour market. This has been at the root of household income growth. During the current upturn, employment has responded forcefully to GDP growth. The unemployment rate currently stands at 7.5% of the labour force, very close to the historical low seen in the pre-crisis years.

Strong job creation has contributed to reducing labour market slack. This has begun to be mirrored in wage growth and in an increase in labour income, which has enabled consumption to play a key role in euro area growth. That said, labour continues to be underutilised in some economies in the area.

Yet in the euro area as a whole, the rise in wages and in unit labour costs has not fed through to prices, which has prompted a contraction in business mark-ups. In fact, the globally prevalent moderate inflation and growing competitive pressures, along with the increased uncertainty over future euro area exports, would account for firms' heightened caution when passing through labour cost increases to the prices of their products.

The upshot is that, excepting the oscillations associated with more volatile items such as energy or certain services (e.g. tourist packages), the various measures of core inflation are holding at very moderate levels of around 1%, far removed from the monetary policy reference. Indeed, since 2013 euro area inflation has averaged 0.9%, practically half that observed during the first 10 years of EMU (2.1%).

In parallel, the financial markets-based indicators of long-term inflation expectations have fallen forcefully since late last year and are holding at very low levels. That broadly coincides with the signals captured in opinion-based surveys. These indicators are habitually used to ascertain how anchored inflation expectations are with respect to the ECB's medium-term objective (inflation rate at below, but close to, 2%). True, most of the reduction in inflation expectations according to the market indicators appears to be due to the decline in the

[5] In France, real GDP rose by 0.4% quarter-on-quarter in the last quarter of 2018, while in Spain it rose by 0.7% in the first quarter of 2019.

inflation risk premium. But the level of this premium is in negative territory, indicating that agents would appear to be hedging against the risk of very low or even negative inflation rates.

As regards the medium-term outlook, the latest ECB survey of professional forecasters showed an average forecast of annual HICP-based inflation of 1.3%, 1.4% and 1.5% for 2019, 2020 and 2021, respectively, marking a downward revision of 0.1 pp for each year compared with the previous forecast. For 2021 it is even below the Eurosystem's June projection, which placed it at 1.6%.

There is also evidence that euro area economic agents are setting greater store by recently observed inflation when determining their inflation expectations and, therefore, their price and wage-setting decisions. The persistence in recent years of very moderate inflation rates might be behind this.[6]

In this setting, the risks to the euro area growth outlook remain clearly tilted to the downside. They reflect the prolonged presence of protectionist tensions; the uncertainty associated with geopolitical factors (such as Brexit and the political uncertainty in Italy); the doubts over the intensity of the ongoing slowdown in China and the possible repercussions for the global economy as a whole; and the vulnerabilities that some emerging economies, such as Turkey and Argentina, continue to evidence.

There are also some structural factors suggesting that a setting of low growth, modest inflation and, consequently, low interest rates might prevail over time.

Among the main determinants is population ageing. This is a common trend in the advanced economies whose consequences go far beyond public finances and health systems. Ageing alters economic agents' patterns of saving, investment and labour supply, and affects the potential growth of economies by reducing the working-age population and its productivity, among other factors.

The other major challenge the European economies must face is the lower rate of productivity growth. This is admittedly common to other advanced economies, and is in contrast to the technological progress of recent decades. But we cannot ignore the fact that productivity growth in Europe is far lower than that observed in the United States. In some countries, such as Italy, productivity per employee has even stagnated in the past two decades.

Low inflation is a common trait of other advanced economies and a fundamental challenge for most central banks. It therefore continues at present to be one of the central matters for discussion in the academic arena and on the monetary policy boards of the Eurosystem, the Federal Reserve and other central banks.

In its latest *Annual Report,* the Banco de España dedicated special attention to these matters. The report highlights the considerable uncertainty over the factors that may be checking the rise in inflation at the global level. They include most notably structural phenomena, such as population ageing, globalisation, the expansion of value chains and

[6] See Chapter 2, "The determinants of low inflation in the euro area and in Spain", in the *Annual Report 2018,* Banco de España.

the attendant increase in competition, along with swift technological progress and the emergence of new forms of marketing and major sales platforms. Moreover, at certain times more transitory factors may have played a part, such as low oil prices and the considerable slack in some labour markets further to strong job destruction during the crisis.

The monetary policy response to an extended scenario of slow growth and moderate inflation

The complexity this setting poses for economic policies in Europe is most considerable. I shall refer first to monetary policy.

The context of low inflation and slow growth has given rise to a broad consensus on the ECB Governing Council. This is namely the need to maintain a significant monetary policy stimulus that can help anchor the economic expansion and ensure that inflation is on a sustained path towards the medium-term reference.

Since the end of the asset purchase programme (last December), the main tool for maintaining the monetary stimulus and anchoring agents' expectations has been interest rate policy and forward guidance. In June 2018, then, it was determined that policy interest rates would hold at current levels until, at least, the summer of 2019 and, in any event, until inflation should converge in a sustained manner towards levels compatible with price stability. That is to say, our forward guidance has twin strands: the first is linked to a specific date until which the Governing Council commits not to raising interest rates; and the second makes these increases conditional upon convergence towards our medium-term inflation aim.

Forward guidance has also been strengthened by the maintenance of the policy to reinvest the principal payments from maturing securities purchased under the asset purchase programme for an extended period of time past the date when the Council starts raising the key ECB interest rates.

However, in light of the weakness of the macroeconomic figures, the decline in inflation expectations and the conjunction of numerous sources of risk, communication by the ECB Governing Council has progressively been adjusted towards a more accommodative monetary policy.

Specifically, at its July meeting, the Council added further accommodative bias in its communication on policy interest rates. It signalled that it expects rates to remain at their present or lower levels at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to its aim over the medium term.

The Governing Council also acknowledged that inflation rates, both realised and projected, have been persistently below levels that are in line with its aim. That is to say, the actual and projected inflation levels I have referred to cannot be considered to be compatible with the ECB's mandate.

It further stressed that, if the medium-term inflation outlook continues to fall short of its aim, the Governing Council is determined to act, in line with its commitment to symmetry in the inflation aim.[7]

The notion of symmetry here means that the ECB can tolerate both upward and downward deviations in relation to our inflation aim of "below, but close to, 2%", provided it is foreseen that inflation will converge on our medium-term objective. It also means that the figure of 2% is a reference for average medium-term inflation, but it is not a cap that prevents prices from temporarily increasing at rates of over 2%. Moreover, the concept of symmetry reveals that the Governing Council is committed to acting resolutely both whether inflation is persistently above or whether it is below 2%. It may also be inferred from this symmetry that, since inflation has been below-target in recent years, fulfilment of the aim in the medium term may require it to be above the aim at some time in the future.

Consequently, the ECB Governing Council has announced that it stands ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner. Against this background, we have tasked the relevant Eurosystem Committees with examining options, including ways to reinforce our forward guidance on policy rates and options for the size and composition of potential new net asset purchases.

There is a possibility that durably low or even negative interest rates may have effects on financial stability and bank profitability. It is true that Eurosystem estimates suggest that so far the positive effects, in terms of greater economic activity and improved credit quality, offset the adverse effects on banks' net income. But it is necessary to monitor this matter continuously in order to determine whether measures are needed to mitigate the adverse effects of low rates on the banking system's intermediation capacity. The Governing Council has thus also requested that the Eurosystem's technical committees analyse a potential tiered system for reserve remuneration.

It should be recalled that, in March, new quarterly longer-term financing operations were announced. These will begin to be implemented in September, under very favourable financing conditions, with the aim of maintaining the current low costs of bank funding and, therefore, of overall borrowing by households and firms.

It is perhaps worth reiterating here that the ECB's monetary policy has had very positive effects on euro area activity and inflation.

In fact, by easing financial conditions and reducing financial market fragmentation, the ECB's expansionary monetary policy has substantially contributed to the improvement in the euro area economy. At the same time, it has prevented the period of negative inflation rates experienced by the European economies further to the crisis-induced recession from turning into a deflationary spiral.

Specifically, according to some ECB papers[8] and to in-house Banco de España estimates, it is believed the set of monetary policy measures adopted since mid-2014 will have an

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[7] See M. Draghi (2019), "Twenty Years of the ECB's monetary policy", ECB Forum on Central Banking, Sintra, 18 June 2019.

[8] Hammermann *et al.* (2019), "Taking stock of the Eurosystem's asset purchase programme after the end of net asset purchases", *Economic Bulletin,* 2/2019, ECB.

overall impact on the euro area's real GDP growth and inflation. In both instances this is expected to be cumulatively of the order of around 2 pp between 2016 and 2020.

It should also be underscored that these effects have arisen from the combination of the various instruments used. Beyond their individual impact, these instruments mutually complement and reinforce one another. Hence, the joint application of short-term interest rate cuts, asset purchases, special financing operations aimed at banks and an active communication policy of the part of the ECB Governing Council have all allowed the yield curve to ease in recent years. This has had a most notable impact on financing conditions for all agents, public and private alike, within the area.[9]

It is important this complementarity be maintained with the new measures, should they prove necessary, in order to maximise their effectiveness.

Indeed, following the adjustments recently made to the ECB Governing Council's communication, market interest rates in all segments have continued to decline, and the yield on the GDP-weighted euro area 10-year sovereign bond has fallen to below 0.2%. The sovereign bond risk premia relative to the German benchmark and the yield spreads on corporate bonds have also declined.

Notwithstanding the monetary policy decisions that may have to be adopted in the short term, I believe this setting also calls for some thoughts on the medium-term monetary policy strategy.

It should be borne in mind that, insofar as interest rates hold at levels close to their effective lower bound for a longer period, central banks will have less headroom to cut rates in response to future crises. They also have to resort more frequently to less conventional measures to increase their balance sheets.

This situation has led some central banks to discuss possible alternatives to the current monetary policy strategy, aimed at countering the constraint of the effective lower bound of interest rates. The US Federal Reserve has been most prominent in this connection, conducting a far-reaching review of its operational framework.

In this connection, I am of the opinion that the ECB should launch a similar exercise. Among other factors, it should reflect on a clarification of our quantitative price stability objective, in order to align it with the specific definitions of other developed countries' central banks and provide for better communication and anchoring of agents' expectations.[10] The latest *Annual Report* of the Banco de España, to which I referred earlier, analyses the most favourable and least favourable aspects of several possible strategic options in this area.

[9] See P. Lane (2019), "Policy and Below-Target Inflation", address delivered at the Bank of Finland on 2 July 2019.
[10] See Chapter 3, "Monetary policy design in the medium and long term", in the *Annual Report 2018,* Banco de España.

The contribution of non-monetary economic policies is pivotal

That said, the participation of non-monetary economic policies is essential for shoring up the recovery, entrenching higher growth rates and, thereby, smoothing convergence by inflation towards its medium-term reference.

The need to create a fiscal stabilisation instrument in the euro area

Recent experience has highlighted the difficulty of achieving a more appropriate macroeconomic policy mix for the euro area as a whole under the current framework of rules and institutions in which European fiscal policy operates.

In the euro area each country decides its fiscal policy. Monetary policy, meanwhile, is designed taking into consideration the situation of the euro area as a whole. Attaining an appropriate mix of both would require effective coordination mechanisms or the creation of a fiscal stabilisation capacity for the entire area.

As regards fiscal coordination mechanisms (based on the Stability and Growth Pact), there is consensus on the need for a far-reaching review.[11] SGP arrangements have become excessively complex over time, which hampers transparency in their application, their implementation and, ultimately, their fulfilment. The most evident consequence of this is, across the board, that fiscal policy design has been procyclical in numerous countries and in the euro area as a whole.

In recent years, some countries running expansionary public finances are those whose high debt and structural deficits would have advised a fiscal consolidation drive. The restructuring of public finances in these countries is a priority if it is wished to count fully on fiscal policy as a national macroeconomic stabilisation instrument ahead of any potentially more adverse scenario.

In such a scenario, those countries with more fiscal space might provide a greater budgetary stimulus to their economies, especially bearing in mind that they have been particularly affected by the recent slowdown as a result of their heavy exposure to international trade flows. In the current setting of very low interest rates, the positive impact of the fiscal expansion would not only be greater in the countries pursuing it; it would also spread to the other partners, giving rise to positive spillover effects for the area as a whole. Yet as I have indicated, in the current euro area fiscal framework these decisions are the responsibility of national governments, which hampers their adoption.

The composition of spending is also important. In particular, the growth of public investment continues to be very moderate, following the cuts to it during the crisis. This is set against the major challenges we must face in the coming years in various areas, such as digital transformation, the energy transition, population ageing and, generally, the necessary adaptation of our productive system to a more complex and demanding global environment.

In light of this, it is a great concern that the euro area should still not have fiscal policy tools capable of contributing to a common response to these challenges and promoting a greater

[11] See P. Hernández de Cos (2017), “Rules and Institutions for Fiscal Governance in Europe”, Chapter 9, Euro Yearbook 2017. Fundación ICO.

degree of cyclical stability for the Union as a whole. Indeed, recent Banco de España studies[12] point out that while in the United States the federal budget smooths economic shocks by close to 10%, in Europe this mechanism is non-existent.

The recently created instrument for convergence and competitiveness, while a step in the right direction, lacks stabilisation capacity. It does not incorporate some of the potentially most effective elements, such as European unemployment insurance and the use of European funds to mitigate the impact of specific shocks on certain economies.

The lack of effective macroeconomic policy coordination mechanisms in the euro area is exacerbated when monetary policy comes up against its effective interest rate limits. As I said earlier, this circumstance might become more frequent in the future if we move into a more persistent setting of low rates. Moreover, it is in this setting that the effectiveness of fiscal policy may prove greater.[13]

There is thus a pressing need to create some type of common cyclical insurance mechanism in the euro area. This instrument would help automatically absorb adverse shocks at the aggregate level (symmetric) or idiosyncratic shocks in certain countries (asymmetric). Its dual aim would be to smooth effects in individual countries and safeguard the stability of the euro area as a whole.

Some recent analyses suggest that it would be possible to design a mechanism which, without committing major funds (fewer than the current European budget) and without it entailing permanent cross-State transfers, would provide for a similar stabilisation capacity to that achieved with the US transfer system.[14]

The role of macroprudential policy

We should not forget the role that so-called "macroprudential policy" can and should play.

The introduction of macroprudential instruments to complement the stabilising capacity of monetary and fiscal policies is probably one of the most significant advances in the wake of the international financial crisis.

For the countries belonging to a monetary union, the introduction of these tools is particularly important. This is because it is one of the few instruments available nationally to ensure the stability of the domestic financial system.

In my opinion, macroprudential policy has a dual role to play in the current setting.

First, continuing low or even negative interest rates over an extended period may have adverse effects on financial stability. Macroprudential policy should be primarily entrusted with reacting if some of these risks emerge, actively combating potential excessive debt growth and protecting financial institutions against the hypothetical materialisation of these

[12] See Chapter 4, "Fiscal policy in the euro area", in the *Annual Report 2016,* Banco de España.

[13] See Arce *et al.* (2016), "Policy spillovers and synergies in a monetary union", *International Journal of Central Banking,* 12(3), September, pp. 219-277.

[14] See Chapter 4, "Fiscal policy in the euro area", in the *Annual Report 2016,* Banco de España.

risks. This policy action should affect both the banking sector and the non-bank financial sector, depending on where the signs of exuberance are perceived.

Second, some macroprudential instruments, such as the countercyclical capital buffer (CCyB), can be used to build up capital buffers at financial institutions in times of plenty that can be deployed when conditions worsen. The use of macroeconomic stabilisation mechanisms, such as the CCyB, is particularly significant in a setting, such as the present one, in which monetary policy scope is more limited.[15]

Structural reforms conducive to raising potential growth must be undertaken

It is also imperative to address the structural shortcomings hampering productivity and the generation and harnessing of investment opportunities in the euro area. At the same time, measures should be introduced geared to making all citizens party to the benefits the European Project entails.

These structural reforms, insofar as they are expansionary supply-side policies, are especially appropriate in the international setting I have described, in which the main growth shocks and risks (such as protectionist tensions and the uncertainty surrounding Brexit) place constraints on the global supply of goods and services, competition and productivity and harm the production capacity of the economies affected through the negative effects of uncertainty on business investment.

In addition, and as regards the need discussed above for fiscal policy to provide a macroeconomic stimulus where there is space for this, recent economic literature suggests that there is considerable potential for positive synergies between structural reforms and demand-side expansionary policies. In other words, the same structural reforms may provide a greater boost to economic activity if they are implemented in parallel with expansionary monetary and fiscal policies.[16]

In this setting, the slow progress made by the euro area member countries in implementing the European Commission's structural reform recommendations in the 2019 European Semester is worrying. Reform headway is particularly slow as regards the elimination of obstacles in the provision of professional services and in the network industries, and improving the business environment by reducing the administrative burdens that hinder new start-ups.

Greater efforts should be a priority in at least two areas. First, we must improve human capital and active employment policies to promote the rapid reallocation of workers towards the growth industries. Second, public and private spending on innovation must increase to create new business opportunities. Europe cannot stand on the sidelines as new

[15] See P. Hernández de Cos (2019), "A framework for the Countercyclical Capital Buffer", opening address at the Second Financial Stability Conference, Banco de España/CEMFI.

[16] The reason for this is that supply-side expansionary policies tend to be deflationary. This limits their expansionary effects in a setting such as the present one in which the capacity of monetary policy to accommodate these inflationary pressures by means of further interest rate cuts is relatively limited. See Ó Arce, S. Hurtado and C. Thomas (2016), "Policy Spillovers and Synergies in a Monetary Union", *International Journal of Central Banking,* 12(3), September, pp. 219-277. In addition, structural reforms may be particularly effective in the euro area economies where the private sector remains immersed in a deleveraging process; see J. Andrés, Ó. Arce and C. Thomas (2017), "Structural Reforms in a Debt Overhang", *Journal of Monetary Economics*, 88, pp. 15-34.

technologies are developed and as the United States and China battle for technological supremacy.

In the financial arena, for example, most of the most successful technology companies are headquartered in the United States or in Asian countries.

The increase in public investment should focus on improving transport and communication infrastructures to maintain connectivity with business centres and to promote the development of European value chains and, thereby, regional cohesion.

Moreover, we should not forget the impact that all the latest technological developments may have on income distribution, and nor that of education on employability.

The Banking Union should be completed as soon as possible and a single capital market created[17]

Turning to European governance, in addition to the review of the fiscal framework and the creation of supranational macroeconomic stabilisation instruments, we should progress swiftly towards creating a single capital market and completing the Banking Union.

These two initiatives are key both to the funding of investment and of business innovation, and to achieving a more robust and resilient monetary union in the face of adverse shocks.

Capital markets in Europe are not only less developed than in other advanced economies (few companies tap the capital markets for funding); they are moreover fragmented as a result of differences in regulations (e.g. on insolvency proceedings) and in the tax treatment of debt versus equity.

This has negative consequences for business financing, and for European countries' capacity to diversify risks and withstand adverse shocks. Whereas in the United States more than 40% of economic shocks are absorbed by the capital markets (through the cross-ownership of equity), in Europe this percentage is almost five times smaller.

Less-developed capital markets in Europe hamper business start-ups. It is difficult for them to obtain financing in the initial stages of operating, particularly at those more innovative companies with a higher level of risk, where research and the business concept are pivotal. These intangible assets are difficult to collateralise in a bank loan: therefore, the resort to capital markets is crucial.

Thus, the number of high-growth business start-ups in Europe is almost 10 times less than in the United States and four times less than in China. And nor does the fragmentation of capital markets encourage the savings in some countries to be routed towards profitable investment projects in others.

The financing of European firms would also benefit from the completion of the Banking Union before a hypothetical crisis arises.

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[17] See P. Hernández de Cos (2019), "The need for deepening euro area integration", speech at City Week 2019: The International Financial Services Forum, and P. Hernández de Cos (2019), "Monetary Union: the dangers of a work in progress", Euro Yearbook 2018. pp. 45-64.

This is a far-reaching project of the utmost importance for European construction, which is why it is vital it should not be left incomplete. Following the launch of the Single Supervisory Mechanism and the Single Resolution Fund, efforts should focus on reaching agreement on the start-up of European Deposit Insurance.

Currently, decisions on the supervision and resolution of banks are taken at the European level, while the responsibility for financing deposit guarantee schemes falls on national insurance arrangements. This divergence is not only fertile ground for potential political and institutional conflicts, but it also hinders the creation of a true European banking system.

To progress in this area, it will be necessary to further reduce risks (bank and sovereign alike). But political momentum will also be required to allow a better alignment of responsibilities with effective decision-making capacity and, above all, to provide for the better harnessing of the opportunities afforded by the EU to bring about better risk-diversification and risk-sharing among its members.

Finally, we should also explore creating a common safe asset for the euro area as a whole.

The operations of financial markets and intermediaries require a broad set of sufficiently liquid assets with minimal counterparty risks. This need is greater at times of financial turmoil, given that investors tend to react by accumulating low-risk assets. Within the euro area, the volume of these low-risk assets is insufficient, since the debt of only a small number of countries is considered risk-free. That gives rise to a shortage of such assets and to financial fragmentation. Evidently, an improvement in countries' fiscal positions might help increase the amount of risk-free assets available. But a common safe asset would have additional benefits. It would contribute to weakening the link between bank and sovereign risks, preventing capital movements towards safe assets that might prove destabilising at times of financial tension. And, more generally, it would promote the fairer provision of more stable safe assets for the euro area as a whole.

Conclusion

In short, the global economic situation, and that of the euro area in particular, has recently continued to weaken, weighed down – among other factors – by adverse international trade developments.

Against this background, some of the main risks that have loomed for several quarters over the area's growth prospects have increased and are denting the euro area economy. As I stated earlier, the Eurozone is particularly sensitive to the course of international trade and is directly exposed to the uncertainty Brexit is causing.

Both actual and projected inflation rates have held persistently below the ECB's objective. Against this backdrop, the ECB Governing Council has underscored its determination to act if the medium-term inflation outlook remains below-target, adjusting all its instruments appropriately.

In parallel, improving the workings of the euro area before any future crisis should occur is a pressing concern. To achieve this, progress without delay is needed towards greater financial integration with, namely: the development of a capital markets union; the completion of the Banking Union with the creation of a common deposit insurance scheme;

the introduction of fiscal instruments that improve the whole of the euro area’s economic stabilisation capacity; and the creation of a common safe asset.

We must also achieve healthy fiscal positions at the national level. These can enable budgetary policy to fully develop its stabilising role, resolutely tackle population ageing and address the structural shortcomings hampering productivity and the generation and harnessing of investment opportunities in the euro area.

Lastly, macroprudential policies should be adopted when risks to financial stability are perceived and so buffers may be built up that can be used ahead of more adverse macroeconomic situations.

Thank you.