IMPLICATIONS OF INFLATION AND DE-GLOBALIZATION FOR FINANCE

IRENE TINAGLI

Chair of the Committee on Economic and Monetary Affairs - European Parliament

Coordination is the magical word at this time

After more than a decade with price changes almost permanently below the European Central Bank's target, in the last year we have been faced with a sudden and unexpected increase in inflation. While at the beginning this increase was mainly driven by a sharp rise in the price of energy raw materials, only partly justified by actual mismatches between supply and demand, as the months go by, inflation seems to be driven by endogenous factors, among which emerges in particular an average increase in mark-ups, albeit with a strong heterogeneity between countries, sectors and industries.

At first glance, inflation and negative real interest rates may appear to be a big opportunity for some sectors, especially the financial sector. However, as time goes by, inflation is not a good deal even for banking and finance. Indeed, the longer a period of inflation lasts, the more difficult it is for investors to predict future price trends. As a reaction, they shorten the time horizon of their choices. The result of this process may be a progressive drying up of medium and long-term financial markets and of investment. All of this may shorten the average duration of financial and non-financial investment, thus determine a negative impact on potential economic growth.

The fight against too-high inflation is therefore crucial. The ECB has taken up its role and engaged in raising the interest rates and in monetary tightening. What is important is that we should not be too demanding on what monetary policy can do in this context. If we give the idea that central banks can always have full control of inflation, we might risk endangering their credibility and therefore their own effectiveness. We should not ask them too much, but we have to ask them what is right.

> As time goes by, inflation is not a good deal even for the financial sector.

Coordination is the magical word at this difficult time. However, coordination can be understood in different ways.

First, coordination among central banks at international level. As the most recent OECD economic outlook shows, when all central banks hike interest rates simultaneously, the negative impact on GDP is larger but the impact on inflation is smaller because the foreign exchange channel is muted. Coordination would therefore be essential, although we all know that it is historically extremely difficult to get.

Second, coordination between fiscal and monetary policy. By its nature, fiscal policy can be more targeted than monetary policy and therefore may help households and firms to face extra-large energy bills and can reduce possible second round effects on wages, making central banks' task easier. Monetary and fiscal policy can be synergic in the sense that if you use both, you can use less of each if taken alone. Of course, the coordination of monetary and fiscal policy is not easy too, in particular in the European Union where monetary policy is centralized while fiscal policies are left entirely to individual Member States. However, an uncoordinated solution may have a strong negative impact on real economy as well on financial stability.

Third, coordination within Member States or within the Union. The risk of price-wage spiral is not a monetary problem. It is a distributional conflict. As Olivier Blanchard recently explained, this conflict stops only when the various players are forced to accept the outcome. Forcing the players to accept the outcome, and thus stabilizing inflation, is typically left to the central bank. By slowing down the economy, it can force firms to accept lower prices given wages, and workers to accept lower wages given prices. In this perspective, leaving the fight against inflation entirely to central banks is probably not the most efficient way to stop prices increase. Other policy tools might be useful to resolve this distributional conflict without necessarily having to go through a major recession.

Last, but not least, coordination is important on a broader international level, in particular with regard to the Inflation Reduction Act (IRA) adopted in the United State and other measures that might have the effect of trade barriers or incentives to delocalize Europe's renewable energy industry.

While IRA's objective is to promote clean production and innovation in clean technology, and to accelerate climate efforts, some component of that act and the large amount of funding mobilized might pose challenges for transatlantic trade and investment. It is therefore important that the European Commission works for a mutual agreement with the US Administration based on the strong relationship/ties we share.

EMMANUEL MOULIN
Director General of the Treasury - Ministry of the Economy, Finance and Industrial and Digital Sovereignty, France

The case for a European financial strategic autonomy is more relevant than ever

In April 2022, under the French Presidency, the Council adopted ambitious conclusions on European financial strategic autonomy. Such conclusions were based on the consensus that the EU faces massive financing needs for the transition to a sustainable economy, estimated at € 350 bn additional financing every year until 2030, which requires a mobilization of the private sector.

One year later, the need for true strategic autonomy is more relevant than ever as the situation on financial markets has deteriorated and given protectionist tendencies in the world.

First, the economic context has profoundly changed. Geopolitical uncertainties triggered by Russia's war in Ukraine, the deterioration of the economic situation and the tightening of monetary policy have affected the European financial sector. It led to an increase of the interest income earned by financial institutions, but also to a renewed cautiousness in asset prices, particularly in the loan portfolios of lending institutions, and emerging vulnerabilities of the non-bank financial sector, due to potential market corrections. The recent stress that followed the collapse of the Silicon Valley Bank and the takeover of Crédit Suisse has added further market pressure on the European financial sector. Nevertheless, European banks are generally in a very strong position when it comes to capital and liquidity.

French banks are also well preserved from credit risk, and deposits are stable thanks to fixed rates, regulated savings and macroprudential framework. It also shows that when confidence is at stake, we are as strong as our weakest link. This is the best reason not to go for a two-tier system in banking regulation. But this is also true of supervision, and here as well we are better off the progress made with the implementation of the SSM: quality of supervision is key, and Europe is well endowed in this regard.

The IRA has underlined the urgency for the EU to unlock additional financing for its transition.

Second, the Inflation Reduction Act, signed into law last August in the United States, has underlined the acute need to develop and target additional financing solutions for the transition in the EU. As the US proposal aims to catalyze investments in domestic green technologies through significant federal funding. In February, the European Commission presented a Green Deal Industrial Plan to enhance the competitiveness of EU's net-zero industry, which included public support to unlock huge amounts of private financing, and included legislation covering technologies that significantly contribute to decarbonization. Overall, according to estimates, the EU will mobilize €400-500 bn over 2021-2027.

From these observations, I draw the urgent need of a coordinated response at European level.

In the short-term, the priority is to reach an agreement on banking and insurance regulations, which will increase further their resilience while ensuring their capacity to provide sufficient financing to the European economy: in the current juncture, both aspects are needed at the same time. This should be complemented by resolute actions to complete the Banking Union, which will further strengthen the resilience of the overall EU banking system and reduce perceived risks for savers and investors. As a first step, we look forward to the Commission's proposal on the crisis management framework.

In addition, the launch of a European Sovereignty Fund, to finance joint EU projects in clean technologies, would certainly help to unlock private capital to reach the goals of the Green Deal. In order for such plan to be a success, it is even more critical to ensure that EU and national governments put in place conditions to build a strong and competitive European home-market for financial services. Such home-market is best-placed to support EU strategic goals, by complementing public money and ensure that European private pools of capital can meet the European economy's strategic financing needs.

To ensure that capital is appropriately channeled towards strategic and sustainable activities, the legislative proposals on Capital Markets Union must be completed before the end of the current legislative cycle. It will help to diversify the sources of capital, increase retail participation and better channel long-term capital towards riskier projects.

The Capital Markets Union should catalyze the EU sustainable finance framework and support allocation of financial flows towards sustainable activities. In addition, trust from retail investors on green financial products should be increased, by addressing greenwashing concerns and their long-term detrimental effects. National measures could also help channel private capital towards long-term ESG funds.

Mobilizing these levers could unlock the financing needed for the ecological and digital transition without interruption. In short, we are already well equipped to weather the current turmoil and uncertainties, but we should definitely take a very proactive stance to strengthen the European financial sector as a key means of funding the future.

VITTORIO GRILLI

Chairman of the Corporate & Investment Bank, EMEA - J.P. Morgan

Inflation, de-globalisation and the provision of finance in the EU

Inflation and de-globalisation are two macro-trends impacting the financial sector. Policymakers should keep these in mind as we consider priorities for the next EU legislative cycle.

Inflation

The Eurozone is still experiencing higher than expected inflation into early 2023. This is likely due to lagging effects of the war-induced energy crisis from last year, which itself came on top of COVID-induced supply chain issues and post-lockdown reopening effects. For example, the Eurozone is likely only now seeing the effects of high gas and electricity prices on processed food, while unprocessed food price inflation has declined. Negotiated wages have also remained on an upward trend in recent months, which might lead to continued services price inflation. These lagging effects should be temporary, meaning over the medium term, I would expect Euro area inflation to gradually return to its 2% target.

The banking sector is already seeing some effects of recent inflation following several years of expansive monetary policy. Some of the large amount of government debt in the market has ended up on the asset side of banks, especially as such debt has been considered highly liquid by regulators, carrying very low capital requirements due to its supposedly risk-free nature. The recent moderation in macroeconomic policy, including a reversal of asset purchases and higher rates, should have normally helped an ailing banking sector with increased spreads.

However, the rapid rise of interest rates has also placed heightened focus on the potential for a deterioration in the fair value of held-to-maturity portfolios, including those which are composed of risk-free government debt. This should give pause for thought on how risk-free debt is treated. Rising rates also hurt certain banks more acutely where interest rate risk was not appropriately managed and which had a highly concentrated and flighty deposit base.

While the regulators and the industry have made considerable progress with regards to improving the resiliency of the banking system through more stringent capital, liquidity and other requirements, particularly for the world's largest banks, there is more work to do to ensure that the right set of requirements are applied to institutions of different sizes.

> **The EU should remain open to international financial markets, which fortifies its resilience.**

De-globalisation

The recent banking troubles are a reminder of problems with high inflation. However, a trend towards de-globalisation could act as an obstacle to a return to pre-COVID and pre-war levels of low inflation. Empirical evidence is clear that globalisation, especially in the case of European trade with Asia, has had an important deflationary effect over the past decades. Reversing this trend will likely keep inflation higher than it otherwise would have been.

Arguments for strategic autonomy are based on increasing the EU's resilience in specific strategic sectors, where trade flows should no longer be the main determinant for openness. The experience of COVID has shown where Europe has vulnerabilities in some of its external dependences. However, applying the EU's strategic autonomy objectives in the financial sector should be handled with care. By their nature, banking and financial markets increase their resilience and quality through the strength and breadth of their network. The more national they are, the less resilient they are. The transatlantic nature of financial markets is a sign of strength.

Part of a concern about "reliance" on US banks relates to the incorrect perception that all non-EU banks retreat to their home markets in times of crisis. However, the opposite has happened. For example, JPMorgan increased lending by >20% during COVID in 2020. Similarly, non-EEA firm market share in syndicated lending was more-or-less stable between 2019 (36%) and 2020 (33%). Rather than retreating, the participation of global firms in the EU system brings added competition and market depth, to the benefit of EU clients. The EU should remain open to international financial markets, which fortifies its resilience.

Policymakers should keep this in mind when looking towards the next EU mandate. The objectives of the Capital Markets Union (CMU) – open and integrated EU financial markets – should be taken forward with even greater levels of ambition. Recent events have shown how more diversified sources of financing in the EU and relatively less dependence on bank funding increase resilience. Good progress has been made since the European Commission's 2015 CMU Green Paper, including on covered bonds, private pensions, long-term investment vehicles and listing rules.

Going forward, fundamental securitisation reform should be a key part of these efforts to reduce pressure on banks and open up lending to help support the economy.

Inflation and de-globalisation will impact financing in the EU. Policymakers should therefore ensure they draw the right lessons for the sake of financial stability and growth as they consider priorities for the next EU cycle.

KRISTINE BRADEN

Head of Europe and Chief Executive Officer of Citibank Europe plc - Citi

Access to global finance supports a strong autonomous Europe

The global economy is going through a challenging time - again. A broad-based economic slowdown, with inflation higher than in multiple decades, the cost-of-living crisis, tightening financial conditions and Russia's invasion of Ukraine, all weigh on the outlook. All of that was before the fate of SVB rattled markets. At the same time, there are good reasons to be optimistic about Europe's ability to weather the storm.

The EU has demonstrated it can respond quickly in crisis, with a targeted fiscal and monetary policy response. Unemployment is at its lowest since the inception of the Euro in 1999. At 3.3%, real GDP growth in 2022 was higher than in the US (1.8%) and better than the global average (3.1%), with southern Europe outperforming.

This does not mean that policymakers and business leaders should rest on their laurels. Ongoing external shocks require companies, the financial sector, and governments to respond and adapt. After years of growth in global trade in goods and services, the pendulum has started to swing the other way. Production bottlenecks and geopolitics have led businesses to reevaluate their supply chains and realign production processes. Governments are seeking to build capacity in strategic industries to decrease their dependence on third country suppliers and increase their ability to act autonomously. On both sides of the Atlantic, this has led to a reappraisal of subsidies and state aid.

In many ways, this is a predictable response. It is right for Europe to strengthen its position in the world. For financial services, this could be achieved by promoting the euro as a key currency in global trade. A Central Bank Digital Currency will help safeguard Europe's sovereignty in the digital space. And the integration of capital markets through the finalization of CMU would be an enormous boom for Europe's capacity in financial services to help companies raise capital.

Recent progress has been admirable. The introduction of a consolidated tape for equities will end an important source of fragmentation. The Listing Act will provide a boost to Europe's primary markets, better allowing its fast-growing companies to tap into new sources of capital. The recast of the Insolvency Directive has the potential to increase the attractiveness of European corporate debt to investors. New legislation to promote securitization, on which a consensus is emerging, would strengthen a vital funding tool in Europe and enable a channel for borrowers to access capital markets.

The EU has acted fast in crisis. Long-term resilience will require funding and capital flow access.

While European capacity building will bring many rewards, the war in Ukraine has also reminded us about the importance of allies. Close cooperation between partners has increased the strength of the Western world in the face of aggression. Similarly, close cooperation between partners on economic and financial affairs will make Europe and its allies stronger. This also applies to trade. Access to global sources of funding and financial flow allows companies to become more resilient, grow faster, and create more jobs in the process.

Reaping the benefits of global finance requires a supportive and harmonized regulatory regime. While Europe continues to foster its financial markets, it is also important to ensure its rulebook fosters the participation of global players. Two recent examples stand out.

Firstly, while the financial industry supports the strong ESG disclosure framework that the EU has introduced, applying disclosure rules to the global footprint of third country firms because of their investment in Europe, risks making Europe a less attractive place to invest. The recently passed CSRD applies EU disclosure rules to global issuers with non-equity securities listed in the EU. This is unlikely to help deepen EU capital markets. The CSDDD takes a similarly unhelpful extra-territorial approach. Instead, alignment with other regulatory disclosure regimes would achieve a similar outcome.

Secondly, the recently published EMIR Review proposal contains a requirement for EU participants subject to the clearing obligation to hold an active account at a CCP established in the EU. There they will need to clear at least a certain portion of the derivatives they hold, potentially having to meet a firm quantitative target. Such forced fragmentation of clearing would increase systemic and operational risk, negatively impact the competitiveness of EU-based firms, and in particular EU investors, and is not global best practice. It would also be inconsistent with the ambition of internationalizing the euro.

Europe's efforts to increase its strategic autonomy are an important way to protect its independence in an uncertain world. These efforts should not, however, come at the expense of less cooperation with partners, but instead foster a spirit of mutually beneficial openness. International cooperation, supported by a strong rulebook that underpins access of corporations and governments to global finance, will ensure Europe's economy will continue to flourish.

ODILE RENAUD-BASSO

President - European Bank for Reconstruction and Development (EBRD)

Now is the time to think strategically about trade finance

The Covid-19 pandemic, the war on Ukraine, rising geopolitical tensions and increasingly frequent extreme weather events have inflicted major pressure on supply chains for firms both in Emerging Europe, Central Asia and the Southern and Eastern Mediterranean, the region where the European Bank for Reconstruction and Development invests, and across the world. EBRD's latest Transition Report, fittingly called Business Unusual, focused on such supply chain disruptions and the ways firms have responded to these challenges.

More specifically, we conducted a survey of trading companies in countries where we work. It transpires that around three quarters of firms in emerging Europe that both import and export have recently experienced such disruptions. More than half suffered disruptions to shipments—due to China's zero-Covid policy or Russia's invasion of Ukraine. Remarkably, one in nine firms were recently disrupted by extreme weather such as floods or low levels of water in the rivers used to ship goods.

The EBRD has been active in this area of trade finance since the 1990s, connecting firms which are involved in trading and their banks with confirming banks in partner economies and supporting the development of innovative trade finance solutions. In 2022 the programme was scaled up in a major way, facilitating close to 2,000 trade transactions worth a record €3.6 billion with 91 partner banks. The supported transactions ranged from a modest €3,500 for medical equipment imports to Egypt to large deals to support imports of agricultural machinery to and wheat exports from wartime Ukraine.

Firms faced with supply chain disruptions have so far proved remarkably resilient. Three quarters responded by increasing inventory, finding new suppliers and digitalizing their supply chain management. Of the firms that found a new main supplier, in 80 per cent of cases this new supplier was based abroad. This is significant. Supply chains are fast evolving. But the changes do not have to mean closed borders or less trade.

This is the good news. But there is bad news too. The Asian Development Bank estimates that the financing deficit, estimated at 1.8 trillion dollars in 2020, continues to grow and now probably exceeds 2 trillion dollars. Easing this financing blockage is likely to require a two-pronged approach – mobilising more investors to the sector and streamlining some trade financing processes that have remained relatively unchanged for decades.

Supply chains are fast evolving. But the changes do not have to mean closed borders or less trade.

Institutional investors currently provide only about five percent of the total trade finance funding required. Packaging rated products for institutional investors utilising tools such as specialist funds and securitizations will go some way to addressing the shortfall but technology is likely to provide the most effective response. Increasingly sophisticated trade financing platforms are now using AI to streamline their client's KYC requirements while the adoption of the Model Law for Electronic Transferable Records (MLETR) will likely lead to the emergence of electronic bills of exchange, potentially streamlining settlement times. In February 2023 the first digital bill of exchange was issued to facilitate a trade finance transaction in the sugar sector with no parallel paper bill of exchange being created.

The private sector is formidable at adapting. But policy support from regulators and IFIs are also needed in the key area of supply of goods and services to ensure that blockages do nor occur. It is also critical that disruptions to the supply chain do not contribute to further spikes in inflation, particularly in the energy sector. In the second half of 2022 as a result of Russia's unprovoked war on Ukraine supplies of pipeline gas from Russia were down more than 70 per cent year-on-year and gas prices in Europe reached unprecedented levels, ramping up inflationary pressures across the continent. While those prices have come down since, they remain several times higher than in the United States. In the short term, we may have seen a shift towards fossil fuels.

The hope must be that this is temporary, and that public opinion will support sustained investment in alternative clean energy sources. Trade finance efficiency gains are therefore inextricably linked to energy supply.

Many things have changed since the EBRD was founded in 1991. I believe that our Bank and its mandate to build open market economies are now more relevant than ever. Today's crisis is deep and the outlook cam sometimes appear bleak. Yet in the field of trade finance, as in many others, we also have the opportunity to think strategically and invest in a better future.