The currency union and financial integration

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Ladies and gentlemen,

Thank you very much for inviting me here today. Prime Minister Bettel gave a good overview of the advantages of Luxembourg as a financial centre. From my own experience, I support that view.

When Europe had to establish a crisis resolution mechanism in 2010, it needed to act fast. Normally, when 19 countries set up an international financial institution, that takes many months, years even. But there was no time for that.

So Jean-Claude Juncker, Mr Bettel’s predecessor, suggested to come to Luxembourg. Company law here enabled us to set up a facility in a matter of days. This was the EFSF, the predecessor of the ESM. That was six years ago. And we’re all still very happy here.
Today, I’d like to talk about the progress that the monetary union has made since then. It’s more than many people think. Certainly more than you read in the press. The economy is doing reasonably well. And the euro area has made great strides in improving its economic governance and institutional architecture.

I will elaborate on these points. But my main focus will be on financial integration – the degree to which banks and financial markets operate across borders. Most of you work in the financial industry, so it is an area you are very much a part of. It's also a crucial topic for the ESM. Let me explain why.

When the euro was introduced in 1999, currency risk across countries disappeared overnight. This made it attractive for banks to expand across borders, and for investors to access markets abroad, leading the financial sector to integrate more closely. This was good not only for business, but also for the real economy. On the one hand, better financing conditions created more opportunities and more growth. But in addition, a more integrated financial sector means that an economic shock in one country is more readily shared with others in bad times, without necessitating fiscal transfers. It therefore enhances economic resilience. In fact, the macroeconomic benefits from financial integration had been one of the important economic reasons to adopt the euro. Today, I will share some findings on how financial integration was impacted - first by the introduction of the euro, and then the financial crisis.
Europe has had to deal with two crises in the past decade. First, there was the subprime crisis, which originated in the U.S.. It led to the collapse of Lehman Brothers in 2008, and sent shockwaves through European banks as well. This was then followed by the euro crisis from 2010, which was of Europe's own making.

Years of irresponsible fiscal policies had caused unsustainable budget deficits and mounting debt levels in several countries. Others had become uncompetitive, pricing themselves out of export markets with excessive wage increases. Housing bubbles contributed to the imbalances, endangering the banking system when they burst.

In 2010, markets stopped believing that fiscal policies of countries such as Greece and Ireland were sustainable. Risk premia soared, and it became impossible for these nations to refinance themselves. Losing market access for a country in the currency union had been deemed unthinkable when it was set up and, consequently, there were no mechanisms to deal with it. The survival of the euro was at stake, and joint action was needed quickly.

Since then, countries have done their homework (well, most of them…). They put their fiscal house in order, and adjusted macroeconomic policies. Budget gaps have tightened and, in the aggregate, are below the United States. Competitiveness has returned, and current account deficits have largely disappeared. At the European level, the Stability and Growth Pact was tightened in 2012, macroeconomic surveillance was broadened, and the Commission was given greater powers to monitor countries and discipline them when they break the rules.

My own institution, the ESM, is a lender of last resort for sovereigns in the euro area, a function that did not exist before the crisis. With a total combined lending capacity of €700 billion, we have disbursed €262 billion to five programme countries by now. Four of the five – Ireland, Spain, Portugal and Cyprus – have successfully exited their programmes. Greece is still work in progress, but I do expect it to be able to return to markets next year if reforms continue.

Huge progress has also been made in the area of prudential supervision. Like the rest of the world, Europe is almost done implementing the new rules for the financial sector launched at the G20 summit in Pittsburgh in 2009. But where Europe was different is that it had to catch up with economies like the United States, where prudential supervision is more centralized. The euro zone now has a single prudential supervisor for systemically important banks, the Single Supervisory Mechanism, and the Single Resolution Board, a supra-national rescue authority for troubled banks. With these two institutions, prudential regulation in Europe is roughly comparable to the set-up in the United States. And let me underscore that these innovations – which would have seemed a distant dream only a few years ago – were achieved in record time.

These are impressive results, which show that Europe has come out of the crisis stronger than it was before. And the economy is doing reasonably well. GDP growth is above potential. In per-capita terms, growth in Europe is similar again to that in the US, just like it was for decades until 2009. Income and wealth distribution is much more equal in Europe, and a higher percentage of the population has a job today compared to 15 years ago, despite the high unemployment rate. In the US, the participation rate has decreased significantly.

In short, the overall picture for Europe is looking a lot brighter than what you'd sometimes think if you read the newspapers. There is a long list of good arguments to support a positive view on the euro area. I believe it is important to keep that in mind, without forgetting the challenges Europe is still confronted with. What are these remaining problems, and how can they be solved?

The Brexit vote and the global rise in populism, or the anti-globalisation backlash, have changed the way I think about such questions. It is clear that now is not the time for unmitigated calls for closer unification and more Europe. We need to be smarter about where to push for more Europe, and where to pause.

Now, what does this approach of “smarter integration” mean for the economic priorities for the EMU? I will offer some pragmatic proposals that policy makers should - and can - implement. Taken together, they can all be subsumed under the heading of risk sharing, to make EMU more robust and its economy more resilient. Risk-sharing, in my view, is the one key issue where we need to make progress in EMU. Financial integration plays a big role in this.

As I said earlier, risk sharing is the sum of mechanisms through which a shock – positive or negative – to one country’s economy is shared by others. This helps smooth business cycles and makes national economies more resilient. Risk sharing in the euro area is underdeveloped. In the U.S., shocks are evened out to a much greater degree than in Europe. Even inside large countries such as Germany and France, it is more developed than across the euro area, where the capital markets channel is particularly underdeveloped. But even the fiscal channel is much smaller than in the US or in large European economies. Time is too short to elaborate on fiscal transfers today. Instead I will limit myself to financial integration.

More financial integration is one of the best ways to enhance risk sharing. The more two countries are financially integrated, the more risks they will share. Companies will then have access to broader sources of funding, which eases financial pressure. Losses in asset values are spread out over larger groups of investors, with a wider geographic expansion. There will be fewer sudden swings in markets.

The data on financial integration in a striking manner show that monetary union gradually promoted financial integration during the first 10 years of its existence. Fragmentation then dramatically returned during the crisis, through a combination of a drop in confidence and the return of country-specific risk premia. But also under pressure from regulators and through demergers of cross-border banking groups. Then - more recently - financial integration resumed, though it has remained well below its peaks. A closer look at the data will help us define the policies to return to the upwards trend that was so successfully set in motion before the crisis.

One indicator of financial integration is published by the ECB. It looks at money markets, credit markets, corporate and sovereign bond markets. The combined indicator varies between 0 and 1, where 1 is perfect integration, and 0 is no integration. The chart very clearly shows rising financial integration in the 10 years leading up to the crisis, the first decade of the EMU. During the crisis, the indicator rapidly drops. It then recovers from the end of 2012 - when banking union was announced. It is now roughly at half the level where it was before the crisis – still much higher than before the EMU.

Cross-border loans are another indicator of financial integration. The picture here is similar: they are gradually recovering from a drop after the crisis, but are still well above the pre-EMU levels. It has to be said though that – even at their peak of 5.5% percent – cross-border lending in Europe remains limited. There is a strong home bias, which limits risk sharing via financial markets. With cross-border holdings of securities, it’s roughly the same story. They are recovering after the crisis, but are still some 10 points below their pre-crisis peak.

Finally, the cross-country dispersion of deposit rates shows that while integration was severely hit during the crisis, fragmentation has been levelling off over the two past years. The ECB’s quantitative easing policy surely plays a role here – rates have come down across the board.

So the picture is less sunny than when the Commission published a report about the same issue in 2008, at the time of the euro’s 10th anniversary. They found that integration in fixed income and money markets – as measured by converging rates - had been substantial. The impact on equity markets had been less pronounced, possibly because national company law and market infrastructure remained fragmented. Still, there had been some reduction in the home bias of investors, which is measured by holdings of shares issued in their own country as opposed to those issued abroad. This ratio dropped to 60% in 2004 from 80% in 2001 on average in the EU.

The report also found that cross-border retail banking had grown, if not as strongly as had been hoped. Cross-border retail banking remained rather limited. There had been a wave of consolidation between banks, but largely within countries. That picture hasn't improved much. The share of euro area cross-border banking assets as a total of the euro area sector has not recovered after the crisis. It now stands at 14% and is trending down after a pre-crisis peak above 16%. That wasn't exactly stellar either. But at least the trend had then been moving in the right direction.

Enlargement of the EU was one factor contributing to cross-border banking in the early days of the euro. Central and Eastern European economies offered a major growth opportunity, while prospective membership of the euro area made the case for cross-border mergers and acquisitions even more compelling. At the time of the report in 2008, there were 46 European Union banking groups – out of a total of 8,000 – with significant holdings of cross-border assets and liabilities. This relatively small group held more than 68% of the total assets of the EU banking sector. In short, some promising first steps toward a more integrated financial sector had been made.

In conclusion, the crisis has broken a trend towards more financial integration that was set in motion at the start of monetary union 17 years ago. Levels of financial integration are well below where they were 7 years ago. Cross-border banking remains the exception rather than the rule, and banks and their clients still retain a home bias. Now the question is, why is financial integration stalling? Will the trend resume? And what can be done to strengthen it?

One reason why financial integration may have been slow to recover after the crisis is low profitability at European banks. Return on Equity stands just above 5%, well below 12% before the crisis. The large amounts of new capital banks had to raise because of new regulation has rendered them much safer. While that was an intended outcome of the new regulation, it also means that profitability has come down. Total assets, revenues and costs have remained broadly stable, but the denominator in the profitability equation has risen. Banks need to cut costs - and adapt their business models - to fix that. At the same time, investor need to adjust their expectations. Banks are now less risky, so they cannot deliver the high returns from before the crisis. You can see in every text book that safe investments bring modest returns.

In the comparison with US banks, a picture of gradual convergence emerges. Capital ratios have increased on both sides of the Atlantic, and are now higher – on average - in Europe than in the US. American banks have better leverage ratios, though the

gap is narrowing. The same is true for profitability, where European banks are closing the gap.
Non-performing loans are one reason why profitability is low. In countries such as Cyprus, Greece, Italy, Ireland and Spain they exceed 10% of total gross loans, which is clearly too high. It means high direct costs, because of impairment charges. But there are also high indirect costs, because bad loans eat up management and staff time, and are a burden on funding and capital. US banks also have fewer non-performing loans, partially because they went through one crisis, not two like Europe. Still, bad loans have started to drop in Europe, and they are also well provisioned, 52% on average.

It is understandable that financial integration is not on top of the agenda of an industry in the middle of a process of restructuring and catching up. Nevertheless, it is an important issue for the functioning of EMU and the development of the real economy. Let me make four recommendations about what needs to happen. Only two are for banks – the other two are for policymakers.

First and foremost, banks need to aggressively reduce Non-Performing Loans. Adequate legislation needs to be in place to facilitate transactions. Governments should make sure that the right incentives in fiscal treatment are in place to facilitate a speedy loss recognition. Bank regulators – and their political counterparts – also need to commit to tackling this problem.

Secondly, banks in Europe need to cut costs. This means – at least in some countries - reducing the number of branches, and fully deploying digital solutions. But most of all it means sector consolidation. As we have just seen from the numbers, cross-border banking is still underdeveloped. Now I know that in the past, large-scale cross-border mergers did not turn out well. But there have always been examples of succesful consolidation as well. For instance in the Baltics, in Scandinavia and in the Benelux. What we lack are truly pan-European banks. The commercial landscape is still very different from the US, where there are thousands of small and local players, but also large regional banks, while a handful operate from coast to coast on a truly national scale.

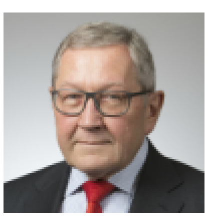
Thirdly, on the policy side Banking Union should be completed. More steps are needed in addition to the new institutions we put in place in the area of prudential supervision. The SSM and the European Banking Authority need to remove national divergences in the application of the EU regulatory framework. There also needs to be a financial backstop for the SRF to make it more credible in the eyes of financial markets. And finally, we need a European Deposit Insurance Scheme, or EDIS, for which different models exist. It is a controversial issue, because the current national systems are very different, and some countries would need to reduce legacy issues with their banks before it can be put in place. It will therefore take a while. But it is a crucial step that will enhance confidence and thus strengthen monetary union.

Fourthly, there is much work to be done on Capital Markets Union. This ambitious project entails harmonizing corporate, bankruptcy and tax law across Europe so that it becomes easier to invest across borders. This would be a big support for private equity, venture capital investment and for financial integration in general. At the same time, it would open up an alternative channel of funding for small- and mid-sized businesses.

Ladies and gentlemen, financial integration is a crucial topic for several reasons. A higher degree of financial integration would be good for the private sector, for the real economy and for the good functioning of EMU. It would open up bigger markets, bring more opportunities, and lead to more risk-sharing. It would also enhance economic resilience – and reduce the need to activate the ESM.

The crisis has interrupted a strong trend towards more financial integration. We know what needs to be done to restore it. Taking these steps would bring tangible benefits for Europe and its citizens. And that is important in light of the growing sentiment against Europe and cross-border cooperation.
Thank you. I am now ready to take some of your questions.

Author



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