The currency union and financial integration

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(Please check against delivery)

Ladies and gentlemen,

It is such a pleasure to be with you in Rome, in this beautiful place. History forces itself upon you here. The Roman denarius was the first money used widely throughout Europe. And it still lives on: until recently, the abbreviation for a penny was "d", for denarius. Rome is also where the treaty that lies at the roots of the European Union was signed. So there really is no better place to reflect on the history of the currency union. Of course that history includes the recent crisis, or I should say two recent crises. First, the subprime crisis hit Europe from its origins in the United States. Then the euro crisis followed in 2010, which was of Europe's own making.

But Europe has come out of the crisis stronger than before. Once again, it has shown it knows how to deal with a crisis – even if the cost can be high. Comprehensive measures by national governments and European institutions put the single currency on a more solid footing. The euro is a success which brings great benefits to European citizens. That's why Europe defended it. And that's why we need to continue to improve monetary union where needed. To this end, I will propose some pragmatic steps to make the euro more robust, and the economy more resilient. I believe you will discuss some of these issues in greater detail during the sessions today.

This conference tries to find the balance between regulation and the entrepreneurial spirit, between safety and growth. My institution – the European Stability Mechanism – is probably more on the safety side of that balance. Our mandate is to safeguard the stability of the euro area. But we need healthy banks for that. And one important sign of a healthy banking sector would be if European banks started to operate across borders more. Or, in other words, if financial integration would pick up again after the crisis.

More financial integration would lead to a better functioning of EMU. It would enhance the degree to which euro area countries share the impact from asymmetric economic shocks. And economic risk-sharing is the one field where the euro area is lagging behind economies such as the United States, or its larger members such as Germany. And a healthier banking industry would contribute to more growth. That is where the balance can be found.

It is not surprising that financial integration took a hit during the crisis. Financial integration thrived after the introduction of the euro. But when the crisis hit in 2008, cross-border banking and cross-border capital flows

caved in, and they are now back only roughly halfway towards the peak from before the crisis. We will look at the numbers in a moment. But right here, let me make one very important observation. The drop in financial integration has sizeable repercussions for growth. One recent estimate from analysts said that the decrease of capital mobility between euro zone countries cost 4 percentage points in terms of GDP and 0.5 percentage points in terms of potential growth. Such numbers show the importance of financial integration for the real economy.

At the same time, let me stress that the EU economy is already doing reasonably well in my view. GDP growth is above potential, so the output gap is closing. In per-capita terms, growth in Europe is similar again to that in the US, just like it was for decades until 2009.
This progress would not have happened without the hard work that Europe undertook during the crisis. Countries have done their homework to a large extent. They put their fiscal house in order, and adjusted macroeconomic policies. Competitiveness has returned, and current account deficits have largely disappeared. Economic policy coordination was strengthened at the European level.
[SLIDE 1]

Europe also set up a range of new institutions. My own institution, the ESM, is as good example. It is a lender of last resort for sovereigns, a function that did not exist before the crisis. We have disbursed loans to five programme countries. Our total loans outstanding are €247 billion, three times as much as the IMF globally. Four of the five countries – Ireland, Spain, Portugal and Cyprus – have successfully exited their programmes. Huge progress has also been made with banking union in the area of prudential supervision, by setting up the Single Supervisory Mechanism, the Single Resolution Board and the Single Resolution Fund.

Of course, Europe is also still facing challenges. One is the UK decision to leave the EU. In my view, the vote is part of a rise in populism that is not contained to Europe. I don't have to remind you of what happened in the US presidential election. Brexit is however, a move in the wrong direction, and a regrettable – if democratic – decision. It has changed the way I think about European integration. We need to be smarter about where to push for more Europe, and where to pause. Next steps can only be modest and need to have clearly defined, tangible benefits.

The lack of risk sharing, which I already mentioned, is a key challenge in this respect. It is the one economic priority on top of my list, when I think about the gaps that should be filled to make EMU more robust, and the euro area economy more resilient.
[SLIDE 2]

Risk sharing is the sum of mechanisms through which a shock – positive or negative – to one country's economy is shared by others. This can take place through three different channels: fiscal mechanisms, credit markets and capital markets. Together, they help smooth consumption, demand and business cycles and make national economies more resilient.

Risk sharing is underdeveloped in the euro area, and the capital markets channel is underdeveloped in particular. In the US, shocks are evened out more than twice as much as in the euro area. Even inside large countries such as Germany and France, risk sharing is much better developed than across the euro area. I will not say much about the fiscal channel. Suffice it to know that there is a trade-off: the more risk sharing takes place through the capital markets channel, the less we need fiscal mechanisms.

Now if a lack of risk sharing – particularly through the capital markets channel – is the main challenge, a higher degree of financial integration is the obvious answer. As we know, financial integration suffered greatly as a result of the global financial crisis, and then further during the euro crisis.
[SLIDE 3]

One useful indicator of financial integration is published by the ECB. It comes in two forms. The first is price-based and looks at 10 main market segments such as credit, corporate and sovereign bond markets. The other is quantity-based, and covers euro area cross-border holdings. The indicators vary between 0 and 1, where 1 is perfect integration, and 0 is no integration. The chart shows how financial integration rose in the 10 years leading up to the crisis, the first years of the EMU. During the crisis, it rapidly drops. It then recovers from the end of 2012 - when banking union was announced. It is now roughly at half its pre-crisis level, though even at that level it is still much higher than before the EMU.
[SLIDE 4]

Let me briefly look at some of the determinants of this trend. Cross-border loans are gradually recovering after the crisis and are well above the pre-EMU levels. However, even at its peak, cross-border lending in Europe is limited, and there is a strong home bias. With the cross-border holding of securities, it is roughly the same story.
[SLIDE 5]

All in all, euro area cross-border banking assets as a share of the total have not recovered after the crisis. They now stand at 14% and are trending down after a pre-crisis peak above 16%.
In short, the crisis broke a trend towards more financial integration that was set in motion in the run-up to monetary union in the mid '90s. Levels of financial integration today are well below where they were seven years ago. Cross-border banking remains the exception rather than the rule, and banks and their clients still retain a strong home bias. The question is, why is financial integration stalling? Will the trend resume? And what can be done to strengthen it?
[SLIDE 6]

One reason why financial integration may have been slow to recover after the crisis is the low profitability of European banks, although a picture of gradual convergence emerges in the comparison with the US. Return on Equity stands just below 6%, 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. Banks need to cut costs - and adapt their business models - to fix that. At the same time, investors need to adjust their expectations. Banks are now less risky, so they cannot be expected to deliver the high returns from before the crisis.
[SLIDE 7]

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. US banks have fewer non-performing loans, partly 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 I believe should be done to return to a higher degree of financial integration in the euro area.
[SLIDE 8]

First, banks need to aggressively reduce NPLs. Adequate legislation needs to be in place to facilitate transactions. The right incentives in fiscal treatment are needed 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 using fintech solutions. But most of all it means sector consolidation. As we have just seen

from the numbers, cross-border banking is still underdeveloped. What we lack are truly pan-European banks.

Thirdly, Banking Union should be completed. There needs to be a financial backstop to the SRF to make it more credible in the eyes of financial markets. And 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 would enhance confidence and thus resilience.

Fourthly, there is much work to be done to create a Capital Markets Union. This ambitious project entails harmonizing corporate, insolvency 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. It is good to see that the Commission recently accelerated part of the time table.

Ladies and gentlemen, financial integration is crucial 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 thus 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 for your attention.

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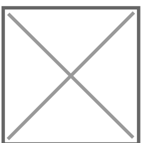

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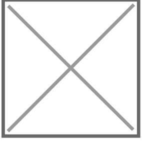

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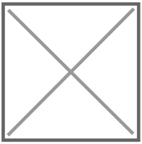

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