Erkki Liikanen: Reforming the structure of the EU banking sector

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland and Chairman of the High-level Expert Group on reforming the structure of the EU banking sector, Berlin, 25 June 2013.

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It is great to be in Berlin. Berlin has inspired many of us through our lives.

In 1961, I was a young boy in school. I listened the news from Berlin with excitement and fear. Two years ago many books were published which gave the broad context to these historical events.

In 1972 as a young member of Parliament I came to West Berlin for the first time and also crossed the border to the east. Detente was only in an early phase. This memory is still vivid in my mind.

In 1988 the IMF annual meeting was organised in West Berlin. As a finance minister I met face to face the demonstrators who did not appreciate our presence at all. I went jogging to Brandenburg Tor and watched to the east, but could not imagine what would happen soon.

In 2007, on the 30th of September Haile Gebrselassie run the Berlin Marathon and made a new world record 2.04, 26. He made history. I took part in the same marathon and lost to him by more than 2 ½ hours. Still the citizens of Berlin gave us both great support. We learned to know Berlin really by foot. What a great experience.

Two months earlier, in July 2007, first turbulences had emerged in the financial markets. One of the premieres was seen here in Germany, even though the root causes were in the US subprime market. We heard first time about IKB.

It is already almost six years ago now. We have seen many phases of the crisis. First was the subprime crisis. Then came the systemic financial crisis after the collapse of Lehman brothers.

The economic crisis or the Great Recession, as it is also called, followed.

In 2010 we were faced with the sovereign debt crisis. And last year we had a wide crisis of confidence in Europe.

What have we learned from this crisis?

These years have taught us many lessons. One is that recovery after a recession which has been triggered by a financial crisis is slow. The leverage goes up fast but deleveraging is slow.

But in Basel last week-end, where Central Bank Governors met at the BIS, it was noted that it is possible that both trend and productivity growth had started to falter even before the crisis. So the financial crisis deepened the economic slowdown, but this was not the only cause.

Last years have also shown that the economic pillar of the Maastricht EMU was not robust enough. The contagion can be an especially pronounced problem in a monetary union and we need stronger framework and stronger tools to tackle it.

At the same time, we need to be fair: this has not been just a crisis of politics or a crisis of the EMU. The economic theory and especially the modern theory of finance have been challenged. This crisis has cast doubt on many commonly held beliefs from the last 25 years. Many textbooks will be re-written.

But still there are issues which we have learnt in economics and economic history which have passed the test. First: A growth model based on ever-growing debt levels won't last. Second: The stability of the whole economy is important, not only the control of public deficits. The economy needs to be competitive. Third: an educated workforce, reliable institutions and a functioning infrastructure provide a foundation for renewing the economy.

How have we changed the EU and EMU?

As to the EMU, the economic governance has been strengthened based on the lessons learnt. First, we have now a stronger Stability and Growth Pact (SGP) and the new macroeconomic imbalances procedure, which pays attention on the balanced development of the whole economy. The governance has also been improved. Second, the crisis management structures have been developed and the ESM has been in place since last October. Third, the banking union is an important step towards further strengthening of financial stability.

We have not only new rules, we have also more market discipline. We need both.

True ownership of the governance is crucial. We need more Europe and we need more national responsibility. A clear separation of responsibilities between Brussels and the member states is very important.

As regards the crisis management structures, the ESM as a crisis fund is just a part – although an important part – of the story. It is of utmost importance that the design of the adjustment programmes relies on state of the art expertise, practices and experience. The programmes must be built on realistic assumptions on the macro outlook and public debt stability. This is the best way to guarantee that the financial support drawn from the ESM remains a bridge loan instead of becoming a permanent transfer. I find also the role of the IMF important and useful. I hope that also in the future the involvement of the IMF is sought for the design of country-specific conditionality and monitoring.

The third part, the banking union, is not yet complete.

The current plan consists of three pillars:

1. Single Supervisory Mechanism (SSM)
2. Single Resolution Mechanism (SRM)
3. Harmonized deposit guarantee schemes (DGS)

The setting-up of the Single Supervisory Mechanism is progressing. Two months ago the informal Ecofin Council in Dublin reached a political agreement over the single supervisory mechanism for banks. The SSM should be fully operational one year later.

The next step is to agree on the Single Resolution Mechanism and the bail-in rules. It is also important to get the details right. Like monetary policy, a successful bank resolution mechanism relies on credibility. To achieve credibility and to prevent moral hazard, central resolution authority must be protected from political pressures by a clear and narrow mandate.

Protecting a sovereign against contagion from a weak financial sector is not the only goal of the banking union.

The banking union should also protect banks against contagion from a weak sovereign. It should allow the private sector to maintain access to credit even if the solvency of the sovereign is in doubt. This would help to restore the credibility of the no-bailout rule, support market discipline and reduce moral hazard.

What has the ECB done and why?

During this crisis monetary policy has had a strong stabilizing role during the crisis in all advanced countries.

In 2008 and 2009 policy rates were quickly lowered to historically low levels in the United States, United Kingdom and also in the euro area. In addition, many central banks have used unconventional monetary policy tools. As a result, central bank balance sheets have grown.

In the euro area, the primary objective of the ECB's monetary policy has been, is and will be to maintain price stability. The Governing Council of the ECB has defined price stability as the year-on-year increase in the HICP below but close to 2% over the medium term.

During the crisis the main policy tool of the ECB Governing Council has been the conventional policy rate.

The unconventional measures of the ECB have focused on repairing the impaired monetary policy transmission: to narrow the existing gap between the intended impact of policy rates and the actual rates that the households and firms encounter.

In the euro area the role of the banking sector is crucial for the transmission of monetary policy. Two very long (3-year-long) refinancing operations were conducted to remove liquidity uncertainty and facilitate the function of the euro area money market. Again, the final objective was to improve the transmission of the proper monetary policy.

Another crucial segment in the monetary policy transmission is the government bond market. Partly due its size – it is the largest capital market in the euro area – it lays the foundation for price formation in other capital markets, like bank and corporate bonds. Government bonds are also important repo instruments.

A year ago, in spring and summer 2012, fears of a break-up of the single currency area and the associated implicit exchange rate risk led to several tensions in the euro area capital markets. As a result, the steering of monetary policy was not functioning fully, or was, in part, not functioning at all.

At the same time, economic indicators pointed to a significant credit crunch and a severe decline in economic activity. As a result, there was a risk of an incipient deflationary spiral; the primary goal of the Governing Council – price stability – was not ensured.

Against this background, the Governing Council set up the OMT programme. There are three crucial elements in the programme.

First, a necessary conditionality is to ensure that the Member State remains under considerable pressure to implement reforms and maintain fiscal discipline.

Second, this necessary conditionality is not yet sufficient. In addition an OMT transaction must be warranted from a monetary policy perspective. This decision will be made independently by the Governing Council of the ECB.

Third, the transactions will be discontinued during the quarterly EFSF/ESM programme evaluation period. The continuation of OMT transactions requires that the programme remains on track.

The OMT is designed to stay strictly within the mandate of the ECB.

Central banks have been able to play a stabilising role first against the forces of the financial collapse and then supporting a recovery of the real economy.

But the central banks cannot repair the balance sheets. They cannot consolidate the public finances. Central banks cannot implement the structural reforms.

Everyone has to take his or her own responsibility.

We need more growth. How can we achieve it?

The pace of recovery in advanced economies has been disappointing. Still between 2001 and 2007, they grew 2.3%. Between 2010 and 2012 annual average was 1.3 %. The BIS report from 23 June 2013 reads: “The only major exception is Germany, which bounced back from a period of stagnation in the early 2000s”.

The lower growth reflects lower employment with lower productivity growth. This holds true for Europe, too. A lot of research tells that rigidities in ***product and labour markets*** go hand in hand with lower productivity and employment. Even though changes have taken place, pockets of high regulation still remain especially in the service sector. OECD indicators tell that further liberalisation of product markets would allow many countries to raise their employment rates. Liberalising entry into regulated sectors can be an important source of investment and job creation. Product market liberalisation is a way to enhance growth.

The reforms in labour market are also very important. When economies with imbalances recover from downturn there is a major need to reallocate resources for example from real estate and construction sector to new areas.

Demography also calls for labour market reforms. In the coming years in many countries a greater number of people will retire than enter the labour market. We need reforms to increase the labour supply.

How is public sector consolidation progressing?

Many advanced countries have raised their public debt to high post-war levels. High debt levels make countries vulnerable, put a drag on growth and limit their room for countercyclical policies.

This we do know. We have discusses and monitored the public debt closely last years. BIS is an international organisation with high reputation. How did they see the debt development? According to BIS: *“the largest adjustment has taken place in economies facing financial market pressures, Greece is expected to improve its underlying primary balance by almost 17 percentage points of potential GDP by the end of 2013, while Ireland and Portugal are expected to have improved theirs by 7.3 and 6.8 points respectively”.* For Spain the figure is 8.3 and Italy 5.1.

These are not small figures, we must admit.

Still, the work must continue. All countries need a healthy primary surplus to take care of their borrowing costs. Often the most critical question is how they succeed in curbing the expenditure related to pensions and health care.

On banking

I spoke about the banking union.

Banks have a vital role in providing finance to households and firms. This holds true especially in Europe where the share of the banks in the financing of companies has traditionally been large compared to capital market financing. It holds especially true in the case of financing of SME’s.

So, it is important that the regulatory reform as a whole supports and strengthens the banks´ ability to provide socially vital financial services efficiently. Various banking models can be successful in this task, if sufficient competition is maintained and decision-making is not distorted by expectations that some banks are too big or too important to fail.

The key objective is to ensure a banking sector that is capable of financing the real economy and fulfilling its other important functions. At the same time, this objective cannot be achieved without restoring and further enhancing the resilience of banks and the confidence in the banking sector as a whole.

We need a banking sector that is sustainable and does not rely on any extraordinary taxpayer support.

This is the aim of the reforms, when more capital and better liquidity buffers are required. This is also the objective of the proposals, which aim at separating insured deposits from high risk-taking activities such as proprietary trading in securities. These prudential and structural reforms and the banking union are actually complementary, supporting each other. We should see that they are carried out.