Yves Mersch: Advancing Monetary Union

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Euro Exhibition, Osnabrück, 25 January 2015.

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Ladies and gentlemen,

Euro banknotes and coins are not just a means of payment. The bridges and arches on our banknotes are a symbol of European integration. They stand for the fact that there is a lot which connects us within the Monetary Union, and that our once so divided continent has succeeded in overcoming these deep divisions, as the crisis has recently shown.

Our common currency also therefore stands for shared values. "Stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities" have been some of the accession criteria for membership of the EU since the European Council in Copenhagen in June 1993; "Membership presupposes the candidate's ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union."[1]

The recently published legal opinion of the Advocate General of the European Court of Justice in the case of Peter Gauweiler and the Die Linke party against the ECB on the Outright Monetary Transactions (OMT) programme also refers to these constitution-like shared legal values. This "constitutional compact" underlies European integration and includes the German constitutional principle of constitutional identity review – it does not exclude it.[2]

Recent expressions of solidarity from all over Europe following the barbaric terrorist attacks on staff at the satirical magazine "Charlie Hebdo" in Paris show what a central role the rights to freedom of speech and freedom of expression occupy in our system of values.

These values of freedom are central among those accorded great importance in newer Member States from the former Eastern bloc. With the awareness that the common currency within the EU is evidence of closer integration, the introduction of the euro – especially in countries such as Lithuania most recently – is also perceived as a demarcation from, and protection against, purportedly aggressive hegemonic powers.

This shows that the European Union and the euro area are far more than an amalgamation of independent nation states.

Shared values are all the more important when the cement that typically holds together the parts of a full political union is missing. Alongside a shared identity – a loose concept which has sometimes been maliciously abused in the past, yet one which cannot merely be reduced to a successful football team – or language, this is often long-term transfer payments to even out differences in living conditions. Germany has this in the form of horizontal financial equalisation among the federal states [Länderfinanzausgleich], as well as transfer payments to the states of former East Germany, which are financed by the solidarity surcharge [Solidaritätszuschlag].

It may well be that one day the political will considers fiscal transfers between the Member States of the euro area necessary and desirable. However, that would then require a change

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[1] Conclusions of the Presidency, European Council in Copenhagen, 21–22 June 1993, http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/72921.pdf.

[2] See the Opinion of Advocate General Cruz Villalón on Case C-62/14, Peter Gauweiler, et al. and Fraktion DIE LINKE im Deutschen Bundestag v Deutscher Bundestag (Request for a preliminary ruling from the Bundesverfassungsgericht (Germany)) delivered on 14 January 2015, paragraph 38 ff.

to the European treaties. There is no provision for a transfer union in the current Treaty. And whether you like it or not, that applies to the front door as well as the back door.

This is something which those who call for more (financial) solidarity must realise. More solidarity within Europe in this sense would also require more European control. But we don't yet have a "euro area parliament" with the democratic legitimation for this, or a supranational budget worthy of this name.

At the moment I see correspondingly little willingness from national parliaments to relinquish their budgetary powers in order to centralise them at the European level. The flipside of this coin, however, is that Member States, with their own national budgets, have disproportionately more individual responsibility.

Even without financial transfers, there must be reasons why it is more attractive for Member States to be part of the Monetary Union than to stay outside it. In addition, they must be better off in the euro area than out. In concrete terms, membership of the euro should bring more stability and prosperity.

In this respect, the Monetary Union has already taken considerable steps towards integration. But a common internal market and a single monetary policy alone is not enough to achieve this in the long run.

With stricter budgetary rules for euro area countries, a stability mechanism and banking union, the Monetary Union is in a considerably better position today that it was at the start of the crisis. But despite these steps towards integration we still can't speak of a completed Monetary Union.

To sit back now, given what has been achieved, would therefore be wrong. Developing the Monetary Union further is a permanent undertaking.

As a matter of principle, the prosperity of each individual country in a monetary union always depends on the financial and economic policies of the other Member States. Member States find themselves, as it were, in a community with a shared destiny. All governments are therefore well advised if they take the other Member States into account and coordinate their policies where appropriate. Member States thus not only need a common monetary policy, they also profit when they share more sovereignty in other policy areas.

When I talk about "sharing sovereignty", this in no way means that Member States lose their independent decision-making authority, let alone their national identity. On the contrary, the more sovereignty Member States share, the more influence they can sometimes gain. Let me illustrate this with an example.

Last year Lithuania's finance minister, Rimantas Šadžius, reportedly said, "we already have the euro, it just has a different name". What he wanted to express by that was that Lithuania's monetary policy was significantly shaped by the ECB. From 2002 the litas was pegged to the exchange rate of the euro, and before that to the US dollar. On Thursday Vitas Vasiliauskas, Chairman of the Board of Lietuvos bankas, was allowed to have a say for the first time in the monetary policy of the second-largest economy in the world.

In times of highly interdependent national economies, sharing sovereignty means gaining influence. And precisely this common decision-making for the benefit of all is a prerequisite for Monetary Union being able to bring its members more stability and prosperity.

This is particularly true when it comes to creating a single European financial market. It is this aspect which I would like to go into in more detail today. At the moment, as a logical consequence of the banking union created last year, a capital markets union is under discussion.

Why Europe needs a capital markets union

Europe's economy is characterised by small and medium-sized enterprises (SMEs). They account for two out of three jobs and generate around 60% of value added. And precisely these enterprises finance themselves almost exclusively via the domestic banking sector. In most countries, however, the majority of loans to enterprises are granted by only a few banks. That makes the economy vulnerable towards, and dependent on, this sector.

In the United States, on the other hand, it is quite usual for enterprises to obtain money directly from the capital market. And not necessarily in the state in which they have their headquarters. This form of corporate financing makes the economy much less vulnerable towards any problems in the banking sector. It is, however, significantly underdeveloped in Europe.

In a monetary union one should also expect a fully integrated capital market. That would mean, for example, that a creditworthy entrepreneur from Osnabrück could issue a bond without any problems in the Netherlands. Or an entrepreneur from Lisbon could do the same in France. After all, France, Portugal, the Netherlands, Germany and 15 other countries share the same currency.

A truly integrated capital market would not only benefit the European economy because it would ensure an efficient and location-independent allocation of financial resources. It would also bring with it a greater distribution of risk.

First, spreading risk means striving for a balanced financing mix. If Europe's enterprises do not principally finance themselves with bank loans but also with, for example, corporate bonds, the economy can still prosper when banks are rather hesitant in their lending. Currently in Europe, however, only around 20–50% of debt financing takes place in capital markets. By comparison, in the United States it is around 80%.

Now, we cannot expect to have a completely new financing mix in Europe from one day to the next. That is why a healthy banking sector remains a prerequisite for SMEs to be able to access loans. Over the medium to long term, however, the desire is not to have to rely on this sector alone, but to foster alternative methods of financing, for example by appropriately regulating the securitisation market.

Second, spreading risk means that financial markets within a monetary union should actually function independently of national borders. Economic shocks can then be better absorbed because countries receive a certain amount of protection from the private sector. If, for example, part of a country's assets are held by foreign investors, these investors will also bear a share of the consequences of an economic shock. Such shocks thus have a reduced impact on the domestic economy. A country can also reduce its vulnerability to shocks by holding a geographically diversified portfolio itself. Ultimately, integrated financial markets help to cushion national shocks because companies and consumers can also fall back on foreign capital markets and banks in times of crisis.

Such risk-sharing with the private sector works very well In the United States. According to scientific estimates, around two-thirds of an economic shock are smoothed by capital and credit markets.[3] The European financial markets are much less effective at absorbing such shocks and their ability to do so deteriorated even further during the course of the crisis.[4]

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[3] Sørensen, B. E. and Yosha, O.,"Channels of interstate risk sharing: United States 1963–1990", *Quarterly Journal of Economics*, 111(4), 1996.

[4] Van Beers, N., Bijlsma, M. and Zwart, G., "Cross-country insurance mechanisms in currency unions: an empirical assessment", *Bruegel Working Papers*, 2014/04, 2014; International Monetary Fund, "Towards a fiscal union for the euro area: technical background notes", September 2013, available at http://www.imf.org/external/pubs/ft/sdn/2013/sdn1309tn.pdf.

The design of a capital markets union – regulatory harmonisation and institutional efficiency

The Commission will soon present a first proposal on what a capital markets union could look like in practice. This proposal will then be submitted for public consultation. The details are not yet known, but I would like to share with you some of my ideas about an effective capital markets union.

For me, the term "capital markets union" means more than simply tinkering with existing regulation. It means addressing areas that are politically sensitive as well, such as disclosure requirements for companies, supervision of the financial infrastructure, insolvency law and EU-wide harmonisation of capital gains tax regulation. We have already achieved a great deal in the field of payment systems, having broken down barriers and significantly reduced costs for citizens since we introduced the Single Euro Payments Area (SEPA), although the existing legislation now needs to be implemented with full force. We want to do the same in the medium term for the cross-border use of credit cards: in a monetary union, there should be no "roaming" fees when it comes to making payments.

The basic principle of the free movement of capital goes back to the Treaty of Rome[5] and has enjoyed the same status as the other fundamental freedoms since the Maastricht Treaty. I think it is time that we consider what regulatory and institutional adjustments have become necessary since then so that we can take full advantage of the single capital market.

Turning first to the regulatory dimension, let's stick with our example of the entrepreneur in Osnabrück. If his company wishes to issue a bond in the Netherlands, it will agree with the investor whether the transaction is to be carried out under German or Dutch law. This initially sounds like a relatively simple way to conduct cross-border financial transactions despite divergent national legislation.

However, financial transactions are often far more complex than that. There might be an entire chain of financial intermediaries, meaning that it is not clear for the final buyer what his/her legal claims and property rights are. The account holder's legal position from the moment a security is posted to his/her account varies substantially. In some countries, the account holder has full and undivided ownership. In other countries, he/she has an "inferior" legal position, i.e. he/she holds an indirect interest in a property or just a claim against the account provider.

At the turn of this century, a group of financial market experts, led by Alberto Giovannini, developed a number of suggestions as to how greater harmonisation in the EU financial markets could be achieved. In two reports[6], representatives of the private sector, the European Commission and the European Central Bank presented concrete recommendations on how, for example, regulatory barriers could be broken down.

Almost 12 years have now passed since the second report was published and some of these proposals and recommendations have still not been implemented. For example, we still do not have an EU-wide framework for the treatment of interests in securities.

Drawing once more on the comparison with the United States, a cross-border securities transaction costs at least ten times as much in Europe as it does in the United States.

I think that makes it clear that Europe's economy has a lot to gain from dismantling the relevant regulatory barriers as part of a capital markets union.

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[5] At that time with the caveat: "to the extent necessary for the proper functioning of the Common Market".

[6] http://ec.europa.eu/internal_market/financial-markets/docs/clearing/first_giovannini_report_en.pdf. http://ec.europa.eu/internal_market/financial-markets/docs/clearing/second_giovannini_report_en.pdf.

In addition to harmonised regulation for securities, we should also seek to implement a harmonised legal framework for crisis management. The Council Regulation on cross-border insolvency proceedings has provided a common regulatory framework governing, for example, jurisdictions and the recognition of court judgements. But within this framework, there are substantial national differences, such as regarding the extent to which various stakeholders are protected in the event of an insolvency.

In my view, a single resolution framework for non-banks, i.e. central counterparties (CCPs; in line with the Bank Recovery and Resolution Directive (BRRD)), is also part of a capital markets union. We should also have a comprehensive resolution regime for central securities depositories (CSDs) in order to level the playing field for banks and non-banks.

Those are just a couple of examples. In general, what is important is that financial market regulation be harmonised so that a single European capital market can function smoothly. It is very important to keep in mind that harmonisation and standardisation are not the same thing as seeing everything at par or interfering with cultural identities. You can use a computer in any of the Member States and the connections are configured in such a way that I can exchange keyboards with different language layouts without any problems. This technical standardisation does not therefore stand in the way of language diversity.

But harmonised regulation alone is not enough. We also need institutional adjustments.

If – as in the case of the capital markets union – regulation is to be implemented and applied so that the same conditions prevail throughout the whole EU, then there are, in my view, two main approaches.

The first is where the legislator creates strict rules that leave no room for interpretation. They can then be implemented and applied in a decentralised manner, i.e. at national level, with the result that institutional adjustments are not essential. Alternatively, the legislator may wish to draw up more flexible regulation. In this case, a supranational authority would be needed to ensure that this regulation is interpreted and applied in the same way across all Member States.

Finding this balance between discretionary powers and centralisation comes to the fore, for example, in the context of supervision of securities markets, instruments and market infrastructures. Day-to-day supervision is currently largely done at the national level. We should consider whether this is still appropriate and what role the European supervisory authorities will play in the future. Their tasks and responsibilities are currently being reviewed in Brussels.

Closing remarks

As you see, the capital markets union is a bigger project that cannot be implemented overnight, not to mention the progress that is still needed in terms of integration in other political areas.

But this should not discourage us from getting started on it. Political scientists would tell you that it is completely normal that we didn't have a fully accomplished currency union from day one and that we still don't have it today. Hardly any international agreement was as ambitious at the first attempt as some of the negotiators would have perhaps liked. The United States also needed many decades and went through several crises before its currency union achieved its current form.

The "Four Presidents' Report" (European Commission, European Council, Eurogroup and ECB) presented to the Heads of State or Government in 2012 discusses the need to complete the Economic and Monetary Union. This includes considering a fiscal union and even a political union, which are difficult topics and ones that I have not touched upon today.

Let's remind ourselves that Europe's Heads of State or Government already "laid the foundation for completion of the European Union" with the Maastricht Treaty. This Treaty,

according to former German Chancellor Helmut Kohl, marked “a new, decisive step in the process of European integration that in a few years will lead to the creation of what the founding fathers of modern Europe dreamt of after the last war: a United States of Europe.”[7]

It is time that this affirmation resulted in action.

A completed Union would not mean that Member States give up their national identities. Quite the contrary: they bring their national identities with them into the euro area. That is why we speak of “unity in diversity”. The Euro Exhibition illustrates this: while one side of our coins all share the same design, each Member has its own country-specific design for the reverse side. These designs often bear symbols of national identity, such as Milda, the symbol of freedom, who features on the Latvian euro coins. But go and take a look for yourself! I hope you will enjoy the exhibition. My thanks go to the Deutsche Bundesbank and the City of Osnabrück for inviting me to today’s opening event.

[7] Kohl, H. “Zielvorstellungen und Chancen für die Zukunft Europas”, speech given on 3 April 1992.