Mario Draghi: Cross-border markets and common governance

Luncheon speech by Mr Mario Draghi, President of the European Central Bank, at the Bank of England Open Forum, London, 11 November 2015.

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Summary

Cross-border markets and common governance

Markets have never been more integrated than they are today. In the case of Europe, we benefit from open markets because we need to be able to invest abroad part of the savings that will finance our pensions. The European Union embodies the principle of an open market economy in its Treaties.

But to reap the benefits of openness markets need appropriate governance. For example, people need confidence that contracts entered into will be enforced. Fair rules on competition, property rights and the rule of law are essential. For financial markets this is especially important given their inherent fragility.

Regulations need to be sufficiently sound to preserve the integrity of the market but not so taxing as to suffocate it. To be true sources of opportunity, markets need policing. This makes the market a political construct. In a true market, one that is both open and free, there exists at the level of the whole market the three branches of government: legislative, judiciary and executive.

It is well understood by all that a genuine single market in Europe has to be buttressed by appropriate and credible institutions. But political sovereignty and the market do not perfectly overlap so the question in Europe is which institutions are most appropriate to uphold as much freedom of the market as possible for different members.

The single currency increases the benefits of a single market but also heightens the degree of mutual vulnerability to which member countries are exposed. National policymakers cannot fully protect their citizens from financial instability without pooling more sovereignty over decision-making. Countries that share a single market and a single currency need deeper institutional integration.

The single supervisory mechanism is an example of this. A single supervisor, applying homogenous methodologies, internalises mutual trust. The case is clear that completing banking union is a priority, with a fully equipped single resolution mechanism and uniform deposit insurance scheme.

Cross border markets create a community of interest from which each member stands to benefit. But they also heighten shared exposure to the potential detriment of all, so they need governance. This is true at the global level and the European level. It is even more true for countries sharing the single currency. For them, it is even more important to complete economic and monetary union in all its aspects.

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Markets can be defined by the instruments that are traded on them: oil, gold, foreign exchange, interest rates. But they are also defined by the people who use them. A marketplace brings together people who, by virtue of trading with each other, share common interests. It forms a community. And as for all communities, the protection of each of its members against potential abuse by others requires appropriate governance.

This raises a particular issue for those markets that extend across national borders. It is that issue which forms the topic of my remarks.

1. The benefits of cross-border markets

Cross-border markets are a fact of contemporary life. There have of course been periods of high integration of global trade and finance in the past – the decades immediately preceding World War I were a particularly stark example. But markets have never been more integrated than they are today.

Trade integration is ever more facilitated by technological progress, making the transportation of goods easier and faster; and by the fact that, in a digital age, a rising share of services in global output makes the distance on the ground between producers and consumers less of an obstacle to transactions.

That is why global integration of trade[1] has risen sharply from 39% of GDP in 2000 to 48% in 2014. For the euro area, trade openness has increased from 58% to 66% of GDP over the same period.

The same applies to finance, too – and perhaps all the more so. Capital can be shipped across vast distances at virtually no cost. And there are good reasons why we should want in principle to facilitate cross-border investments.

Financial markets intermediate between the needs of savers and borrowers; they open up a range of opportunities to both, thereby supporting innovation; and they allow risks to be shared among those more willing or better equipped to bear them. All of this applies across borders as well as within borders.

Let me give you an example. Countries, just like individuals, have different needs for capital at different stages of their demographic lifecycle. Those with young demographics exhibit demand for capital from overseas, while countries with more mature populations have excess savings as they accumulate assets for retirement. In the case of Europe, our demographics would justify a moderate current account surplus and capital account deficit. Put differently, we benefit from open markets because we need to be able to invest abroad part of the savings that will finance our pensions.[2]

For all these reasons, the belief that open markets are conducive to freeing human potential, expanding opportunities, and improving well-being is a fundamental principle upon which our societies are built.

In the case of the European Union, the principle of an “open market economy with free competition, favouring an efficient allocation of resources”, is inscribed in those terms in Article 120 of the Treaties. It is also explicitly recalled in the Statute of the ECB that everything we do has to be consistent with that principle.

2. Why a free market depends on appropriate institutions

But it is not enough just to open borders to have free markets. To reap the benefits of openness, markets require appropriate governance.

Indeed, a market stipulates not just the freedom to take part in the market, but also the means to protect that freedom. That means the confidence that contracts entered into will be enforced. It means the assurance that the rules of fair competition will be upheld, that property rights will be respected, that standards and codes will be applied properly. It means, in short, the Rule of Law.

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[1] Defined as the sum of world total exports and imports to GDP.

[2] There are, of course, many other reasons for net capital flows. For example, one would expect capital to flow from richer to poorer and less capital-intensive areas.

For financial markets this is especially important given their inherent fragility. If rules and standards are not effectively applied, it can produce information asymmetries and other destabilising forces which, in turn, lead to sudden reversals of confidence in the market. We have seen in the past how markets have run ahead of regulation leaving them vulnerable to such dynamics.

Here is one illustration: during the crisis, the market for securitised assets was all but destroyed by a collapse of confidence. Lack of oversight allowed excesses to be committed and market abuse to take place. Securities that were previously deemed safe, certainly with some measure of complacency and too much blind confidence, turned out to be very unsafe indeed, and imparted significant losses on their holders.

What is also unfortunate is that the subsequent attempts to re-regulate that market have threatened to undermine the parts that are beneficial to many. There was too much opacity as to the nature of the assets underpinning asset-backed securities, too damaging a breakdown of confidence in the integrity of those who packaged and sold them. And the immediate temptation of regulators was to impose punishing capital charges on holdings of asset-backed securities, independent of their individual characteristics, mixing the wheat with the chaff.

But securitisation in itself is a useful financial tool. It allows the diversifying of sources of funding for many borrowers who, otherwise, would have no access to capital markets. It allows the opening up of new channels of finance for the real economy. And it can allow cushioning the impact on the supply of credit that would otherwise result from bank deleveraging.

In this context, the ECB and the Bank of England took a joint initiative to promote and garner recognition for high-quality, transparent forms of securitisation. This was useful in several ways: first, it sent a clear message to the private sector that key public-sector participants in ABS markets were not abandoning these assets, which had been lagging in terms of issuance volumes and liquidity. Second, it signalled to other policymakers that all ABSs should not be tarred with the same brush. Third, it created a basis for additional coordination between our two institutions which, in an era of increasingly cross-border regulation, is crucial to avoid loopholes and inconsistencies.

This experience with securitisation, then, was an example of what appropriate governance means: having regulations that are sufficiently sound to preserve the integrity of the market, but not so taxing as to suffocate it. That is why I said that free markets stipulate not just the right to take part, but also the means to protect that freedom. To be true sources of opportunity, and to protect the interests of those who use them, they need policing. And that makes the market, inevitably, a political construct.

Consider the case of markets that are truly open – by which I mean, as open as the Single Market of the European Union, where internal frontiers have been abolished entirely, where passporting of services across the entire EU is a right, not a privilege.

In this situation, national governments, or national courts of law, cannot alone provide full protection to their citizens against abuse of property rights or any form of unfair competition that may arise from abroad. Nor can they alone protect the rights of their citizens to carry out business abroad unimpeded by protectionist restrictions. For the market to be truly free, there needs to exist a judiciary power that can enforce the Rule of Law on all, everywhere. It has to have jurisdiction across the entire market.

A judiciary power implements the law, so there must then also exist a legislative power that writes the laws that govern the market in the first place. And in turn, if there exist a legislative and a judiciary, and if they are to have any effect, there must exist an executive power to enforce their decisions.

What this shows is that a true market, one that is both open and free, requires the existence of, at the level of the whole market, the three branches of government. That makes it an eminently political construct.

There is nothing particularly novel or controversial in this statement. Consider for instance, the considerable amount of US legislation and the powers of its government that stem from the very short clause of the US Constitution – the commerce clause – that grants Congress authority "to regulate commerce with foreign nations, and among the Several States, and with the Indian Tribes". And I think it is well understood by all in Europe that a genuine Single Market has to be buttressed by appropriate and credible institutions.

But what is different from the US, of course, is that in our case the area of political sovereignty and the area of the market do not perfectly overlap, and within the market there are some countries that share a currency and others that do not. The question then becomes *which* institutions are most appropriate to uphold as much freedom of the market as possible for different members.

3. Lessons from the crisis for cross-border market governance

For countries that are part of the Single Market and that also share a single currency, as in the euro area, it is clear that a fully integrated banking and capital market and a higher degree of institutional integration to protect that market is of great importance. This is for two reasons.

First, as the vast majority of money is issued by private banks – bank deposits – there can only be a single currency if there is a single banking system. For money to be truly one, it has to be truly fungible independent of its form and independent of its location. That requires stronger common governance of the banking sector in countries that share a currency, so that bank deposits inspire the same level of confidence wherever they are located.

Second, sharing a single currency heightens the degree of mutual vulnerability to which member countries are exposed. The potential spillovers of a breakdown of the market are much stronger, not least because countries do not have their own exchange rate to "bottle up" cross-border capital flows. National policymakers cannot therefore fully protect their citizens from financial instability without pooling more sovereignty over decision-making at the level of the market. Let me again illustrate what I mean with an example.

Before the crisis, the banking market in the euro area relied on the home supervision, host recognition model. Under this model, confidence that standards of supervision were broadly equal relied on mutual trust between supervisors. That trust, however, was weakened by the crisis, causing finance to retreat behind national borders. This manifested in some countries as a "sudden stop" of capital flows, and the resulting financial fragmentation led to the transmission of the single monetary policy being impaired in those areas.

The creation of the Single Supervisory Mechanism, which started operations just over one year ago, was in part a response to that problem. A single supervisor, applying homogenous methodologies, internalises mutual trust. And this not only provides greater protections for citizens, but also brings substantial benefits to member countries. Their financial institutions can fully exploit economies of scale within the single market, without having to contend with different interpretations of rules or different supervisory regimes.

In sum, with a single currency the benefits of a single market are commensurately higher. But the costs of the market fragmenting are commensurately higher, too. For countries that share a single currency and a single market, therefore, the case is clear – I would say almost undeniable – for stronger common governance and deeper institutional integration. Today, that means as a priority completing banking union: a fully-equipped single resolution mechanism and a uniform deposit insurance scheme.

The question of how to safeguard mutual trust is inevitably more complex at a global level. There is no political entity that coincides with the global market, like in the European Union, that would allow the creation of institutions at the level of the market to enforce the rules – at least not in a way that would be politically legitimate and accountable to the community they serve. And this inevitably does not allow as fully open and irreversible a market as we have within the EU.

This issue of the legitimacy of global governance was highlighted recently by the interest shown by legislative bodies, the US Congress and the European Parliament in particular, for the work carried out under the aegis of international bodies such as the Basel Committee for Banking Supervision of the Financial Stability Board, which Mark Carney chairs.

Yet, we need global standards and rules to uphold the freedom and openness of global capital markets. And if they are enforced in ways which are not comparable, then it may not allow for the mutual trust that is pivotal to opening up borders.

The solution we have adopted so far is, I think, broadly the right one: to work as much as possible within the framework of the Financial Stability Board (FSB). The FSB was established precisely to take forward the design of post-crisis financial reforms in a way that would be properly co-ordinated – both geographically and across industry sectors. It has helped deliver a set of reforms that have levelled the international playing field much more than before. In that sense, I think it has struck the right balance between enforcement and legitimacy.

But it is not my purpose here to discuss in depth the merits of such committees, which I believe are a matter of common wisdom. My purpose is to raise only the following point: that the more we want borders to be open, the more we recognise also the potential of integrated markets to produce financial contagion, spillovers and in some cases financial instability, the more we need to have global institutions to regulate those markets.

Conclusion

Let me conclude.

Cross-border markets create a community of interest from which each member stands to benefit. But they also heighten shared exposure to the potential detriment of all. For markets to be truly free, therefore, they need governance.

This is true at the global level and it is true at the European level. But it is even more true for countries that share a single market and a single currency. Those countries have entered into an irrevocable union, built on the fertile ground of Europe’s common values and history, but also on deep mutual vulnerability. For those countries it is even more important to complete economic and monetary union in all its aspects.