Gertrude Tumpel-Gugerell: Financial integration and stability

Closing remarks by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the ECB colloquium "European integration and stability" in honour of Ms Gertrude Tumpel-Gugerell, ECB, Frankfurt am Main,19 May.

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It is my great pleasure to close this Colloquium after an afternoon of inspiring contribution and presentations, stimulating discussion and a lot of food for thought for the future.

It was over 12 hundred years ago here in Frankfurt, where Charlemagne (Charles the Great) introduced a wide reform of the coin system. At the great synod in Frankfurt in 794, he not only harmonized the coins with respect to weight, size and design, he also decided that the new coins would be commonly introduced and accepted, making the "Carolingian Denar" the common currency and means of payment on both sides of the Rhine.

An impressive example of early stage financial and monetary integration, which shows that such integration has been preoccupation throughout history.

This afternoon's discussion centred around financial integration and stability, the challenges of this relationship and the broader link to overall European integration.

Central banks – also the ECB – have always set out the great benefits of financial integration. For very good reasons – I think:

An integrated financial market is the basis for a smooth and equal transmission of monetary policy, it increases the efficiency and overall welfare of the economy, and enhances the resilience of the financial system from risk diversification.

We have promoted the integration of the euro area's financial market with concrete action – particularly in the area of payments systems and market infrastructures, in which I had the pleasure to work on for the past 8 years.

For example, we created an integrated real time large value payment system, TARGET, which today is the first market infrastructure to be completely integrated and harmonized at the European level. [This has been instrumental to the integration of money markets and wholesale banking activities in Europe.] We have also supported very much the creation of the Single Euro Payments Area (SEPA) in the area of retail payments and have decided to setup a fully harmonized platform for securities settlements, T2S.

But despite our commitment and our support for financial integration, we also had to learn – with the experience of the past 4 years in mind – that financial integration and financial stability do not always go hand in hand. Indeed we have witnessed that in a financially integrated market risks can spread and spillover to other segments of the financial market, increasing the likelihood of contagion of financial fragilities and systemic risks.

So has this recent experience changed our view about the benefits of financial integration? Not at all!

It is true that the cause of the financial crisis has many dimensions – which we still need to study carefully. But a key issue has been loose regulation and supervision, opaqueness of financial products and practices, massive mispricing of risk and a distorted allocation of resources.

In my view, financial integration remains not only a fact and necessity of today's financial markets, but an irreversible process, a process that we do not wish to reverse.

Instead, we need a more resilient financial sector!

For this, we need financial integration ***and*** sound policies guarding our markets. Only with appropriate policies, the benefits of financial integration can outweigh its potential risks.

First and foremost, we need to strengthen financial market regulation and supervision. And when I say strengthen, I do not only mean stricter rules, greater buffers and better risk management, but also:

- that regulation and supervision is uniformly applied.
- that banks' business models and corporate governance become more sustainable[, internalizing the costs of their risk taking and potential failure]
- that financial market activities become more transparent with respect to financial innovations, practices and risk assessments
- and that the soundness of the system *as a whole* has to be ensured.

The systemic dimension of financial market actors' – but also governments' – actions was not sufficiently recognized before the crisis. Traditional banking supervision was designed to look at individual institutions' risks in isolation. Today, we know better.

And a lot of progress has been made in this regard. In Europe, we have established the European Systemic Risk Board (ESRB) and three pan European supervisory authorities. And similar institutions were setup across the Atlantic in the US.

I often hear and I am often asked: Is it because we have the euro?

We cannot make our common currency responsible for issues caused by market failure, lack of regulation and supervision and undisciplined fiscal expenditure.

I am convinced that maintaining price stability is the best contribution a central bank can make for macroeconomic, but also financial stability. However, we also have seen that price stability may be a necessary condition for financial stability but not a sufficient one.

Moreover, we have seen that the materialization of systemic risk and financial instabilities can lead to deep recessions with great economic costs, carrying risks for medium term price stability as well.

Does this mean that monetary policy should be used to preserve financial stability? Not primarily!

We should not violate the Tinbergen principle: a separate policy instrument for every policy objective.

The first best policy for preserving financial stability and specifically to prevent systemic risks from materializing is macroprudential supervision.

Of course, we cannot judge yet, the success and the effectiveness of the newly established macroprudential supervisors – here in Europe and across the Atlantic in the US. But, I am convinced that if we are wary on financial innovations, potential activities shifting to unregulated markets segments or entities and we are mastering the analytical challenge of measuring systemic risk, this undertaking will be a very successful one.

I have started my central banking career in the 70ies when the fight against inflation and macroeconomic instability was a big challenge. From this period I have kept my conviction that you have to lean against the wind.

So, I believe, that we as monetary policy makers should not shy away from our responsibility to contribute to preserving financial stability.

Having said that, I believe that we at the ECB are well prepared for this task.

First, with our medium term orientation on price stability, we have the framework to take into account in a systematic way more medium term developments and potential imbalances occurring at that horizon.

Second, our two-pillar monetary policy strategy foresees that we not only take into account economic but also money and credit developments when setting interest rates. Such money and credit development can help to identify financial market imbalances and unsustainable credit and asset price developments and can serve as early warning indicator for financial fragilities.

And third, we have a framework to implement monetary policy in a flexible way, allowing that we can react swiftly when fragilities occur.

Still, we should be modest as well. It is true that before the crisis, we have seen signs of imbalances – imbalances at the global level and imbalances in local markets in the euro area and we have warned that correction could take place in an abrupt manner. But it is also true that nobody – also not at the ECB – has seen such a severe and deep crisis coming.

Therefore, we also learned our lessons:

- that the financial sector is absolutely crucial, for macroeconomic outcomes and monetary policy transmission. This link we still have to better research.
- that public policies at international, but also national level are all intertwined. National policies – macroeconomic and fiscal policies – can have a systemic effect on the whole euro area. It took this crisis to really understand this. And the euro countries need to prove now that it can work, that we can make policies consistent and can recover trust and confidence.
- The euro countries took the necessary steps to pave the way put of the crisis. As a central bank we have made our contribution to overcome the deep recession we experienced only 2 years ago, contributing to bring back trust and confidence.

Now it's time to address new challenges:

First, governments have to work on regaining confidence, putting the necessary reforms in place

Second, the regulatory reform which is on its way has to be fully implemented

And third, the unwinding of our non-standard monetary policy measures has to go forward as financial conditions improve, not least to prevent moral hazard and delay in the needed financial sector restructuring

We should not forget that the European Monetary Union came a long way. The Werner report 40 years ago, the establishment of the European Monetary System 30 years ago, the Delors report 20 years ago and finally the establishment of the European monetary union a bit more that 10 years ago. We must not undermine this great achievement. The serious currency turmoil and fluctuations in the 50 years preceding the European Monetary Union, notably the exchange rate shocks in the 1980s and the crisis at the beginning of the 90s should be a reminder how precious the current achievement of a monetary union is.

Like with financial integration, I believe that the European Monetary Union and more integration and consistency of public policies on a European level is a fact, a necessity and an irreversible process. What we need to ensure are sound and sustainable policies for an ongoing success.

I thank you for your attention.