Vítor Constâncio: The role of Europe in global rebalancing

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the Expert Seminar "Asia's role in the global economy forum", organised by the Official Monetary and Financial Institutions Forum (OMFIF), Singapore, 12 July 2013.

*   *   *

Ladies and gentlemen,

I want to thank OMFIF, particularly David Marsh, as well as all the organisers of this Conference for inviting me to address you today.

In discussions on global economic imbalances, the euro area often played a secondary role. Academic debates about global imbalances prior to the crisis typically involved the United States and Asia, with the euro area largely excluded as its aggregate current account was broadly in balance.

And looking ahead, on the face of it, the same story is largely true.

The policy debate is focused on how the global situation will develop in the presence of two counter-veiling forces: the United States likely moving away from its traditional role as the global "spender of last resort"; and external surplus economies, notably in Asia, still largely relying on an export-based growth model. The euro area, running a non-significant current account surplus, is seen as a largely neutral force.

But this does not mean that what happens in the euro area is irrelevant for other regions. Naturally, the euro area banking and sovereign debt crises have been a cause of concern for the world economy from the perspective of growth prospects and as a possible source of financial turbulence. And the international cooperation that is so vital for the health of the world economy implies that the three regions should achieve their internal balance with growth and low unemployment, maintaining at the same time a long term situation close to external balance. In the present globalized economy this cannot be achieved without cooperation on their macroeconomic policies. Any set of policies implemented by the US, Europe and Asia that does not consistently corrects global macroeconomic imbalances is not sustainable and could lead to new crises.

What I would like to do in my remarks today is to emphasise two specific channels where developments in the euro area could have an important impact on the global economy.

Channel one: rebalancing towards sustainable growth

The first channel is related to the structural adjustment taking place within euro area economies which could, in time, correct the imbalances internal to the euro area thus overcoming a major European vulnerability allowing Europe to make a contribution to global demand and hence global rebalancing.

Euro area countries are currently taking a series of policy measures both to raise their growth potential and to make growth more sustainable.

They are achieving greater sustainability by moving towards an economic model based less on external borrowing and more on internal competitiveness. Indeed, according to harmonised competitiveness indicators based on unit labour costs have all registered significant improvements since 1999, Ireland (–19% since 1999), Spain (–9.5%), Greece (–9%), and Portugal (–6.6%). The loss of competitiveness accumulated until 2007 has been totally offset since the beginning of the crisis. As a consequence, the EU Commission forecast for this year is that all stressed countries will show a surplus on current account with the exception of Greece with a deficit of just 1.1 % of GDP.

And euro area countries are increasing their growth-potential by implementing wide-ranging structural reforms. These include product and labour market measures, but also deeper reforms to tax systems, public administration and the judicial system.

Our monetary policy has been helping this process by improving our transmission mechanism and stabilizing markets. The decision taken last year on the programme of Outright Monetary Transactions (OMT) has been decisive in this respect. Our recent decision to provide forward guidance regarding our main policy rate was also successful in stabilizing financial markets unduly affected be spillovers from the recent FED announcement of future tapering of Quantitative Easing (QE). Europe is behind the US in economic recovery and inflation risks which implies that monetary policy has to stay accommodative for a longer period of time.

Our forward guidance is in line with our policy framework as it does not refer to any date or period of time but is instead totally conditional on developments in inflation prospects, in the economy and in money and credit aggregates – the pillars of out monetary strategy.

At the same time, policy measures are underway at the European level that could help expedite this rebalancing process. These include initiatives by the European Investment Bank to boost lending to SMEs, and the possible introduction of contractual programmes with financial incentives to underpin structural reform implementation in stressed countries. A proposal by the European Commission on the latter is expected before the end of the year.

Channel two: a stable financial system through Banking Union

The second channel through which euro area developments can have a global impact is the process of building a genuine Banking Union in order to ensure a robust banking sector.

As research by for example Borio and Distayat[1] and Hyun Song Shin[2] has shown, developments in Europe were very relevant to global capital flow constellations. Looking at gross rather than net capital flows, financial intermediaries in Europe were by far the most important source of capital flows into the US, not emerging markets as the "global savings glut" theory suggests.

Even today, the total stock of euro area bonds and equities currently held by US investors is worth around 1 trillion euro, while euro area investors hold US bonds and equities worth more than 2 trillion dollars.

All this means that the situation of the financial sector in Europe has major spillovers for the global economy. And therefore the process of stabilising and strengthening the European banking sector, which Banking Union represents, has very important international implications.

Let me now speak about this in more detail.

The situation of the euro area banking sector

It has become fashionable for commentators to paint a picture of the euro area banking sector as a source of persistent financial instability. The common theme is that euro area banks are undercapitalised with potential losses still to be recognized. I do not deny that there still problems to be addressed as I will explain later in my remarks but looking at the more recent data, the situation of European banks is better than present market perceptions and better than what many observers acknowledge.

---

[1] C. Borio and P. Distayat, "Global imbalances and the financial crisis: Link or no link?", BIS Working papers No 346.

[2] Hyun Song Shin, "Global Banking Glut and Loan Risk Premium" 2011 Mundell-Fleming Lecture.

First, there have been steady improvements in solvency positions of many euro area banks. For large and complex banking groups in the euro area, covering about two thirds of total assets, the median core Tier 1 capital ratio reached 11.1% in the first quarter of this year – up from 9.6% at the end of 2011 and 8.3% at end-2009.

Second, euro area large banks have become less leveraged, from a level of 3,3 % of tier 1 equity to 5% now. This was achieved mainly through capital increases.

This point is well illustrated in a recent speech by Thomas Hoenig[3], FDIC Vice Chairman. Indeed, he reports that the bigger US banks show a leverage ratio of tangible equity over tangible total assets of 6.2%, using US accounting standards (US GAAP), whereas the main European Banks have a level of 3.7% when using IFRS accounting standards. However, according to FDIC calculations, if the US banks ratio would be calculated according to IFRS, the same as in Europe, the ratio comes down to 3.8% very similar to the European level. When calculated with the same accounting standards the average leverage ratios of the large American and European banks are quite similar. The explanation for this has to do with netting rules: under the US GAAP the American banks have total assets of 10 trillion dollars but applying IFRS that is changed into 16 trillion dollars. This huge difference explains the difference in the leverage ratios but, importantly, has necessarily to impact also the published risk-weighted capital ratios of European and American banks. This means that the capital ratios are then not comparable although that is many times ignored by market and media perceptions, clearly to the detriment of European banks.

Third, the restructuring efforts in the stressed countries to strengthen their banks with the help of the European Stability Mechanism (ESM) funds have led to improved funding conditions for euro area banks. With the financing provided by the ESM, banks in Spain, Portugal, Greece and Ireland have been recapitalized. Bank deposits in these countries have risen by around 200 bn since September last year, and the cost of both deposit and bond funding for banks has fallen significantly. Euro area banks' issuance of medium and long-term debt has increased and we have also seen a noticeable pick-up in repo market activity.

All these changes have led to lower use of central bank liquidity. Hundreds of banks have made use of the option to repay the liquidity provided through the ECB's three-year longer-term refinancing operations. These repayments amount to some €300 billion, more than half of the net liquidity injection of 500 bn, provided by our two big LTRO operations. Our lending to bank counterparties has declined from 14% of the Euro Area GDP at the peak to around 8% today.

Despite these positive trends, there is still a negative perception in the market about European banks and more measures are indeed necessary.

The fact that improved bank fundamentals have not been translated into higher price-to-book ratios tells us that there is a confidence problem as regards euro area banks. And if this is left unaddressed, it risks creating a vicious circle as a low price-to-book ratio means that it is expensive for banks to issue equity, which might impinge on their ability to raise capital through financial market channels in a cost-effective way.

Towards Banking Union

This is where Banking Union comes in. The transposition to the European level of financial sector policies through building a strong Banking Union can play a pivotal role in rebuilding trust in the euro area banking sector.

---

3 Hoenig, Thomas (2013) "Basel III, a well-intended illusion" remarks at the International Association of Deposit Insurers, (available in the FDIC site)

Banking Union has for now two key components: the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). The creation of a European Deposit Guarantee Scheme which the third component has been postponed for the medium term.

The creation of the SSM, which we expect to be operational next year, should increase confidence in the euro area banking sector through two main channels.

First, the SSM will provide reassurance to investors that supervision is consistent and effective across all participating countries.

The SSM will operate as a single system, with a common supervisory manual applying to all participating banks. The ECB will directly supervise large, systemically relevant banks. While it would be inefficient for the ECB to supervise directly the thousands of remaining smaller banks, we will have the authority to take over supervision of any small bank or group of banks at any moment if deemed necessary. This means there will be no "blind spots" from which financial instability could emerge.

Second, the implementation of the SSM should reduce concerns about hidden losses on banks' balance sheets.

In accordance with the SSM regulation, the ECB will conduct a "comprehensive assessment, including a balance-sheet assessment" of all banks supervised directly. This will apply to around 130 banking groups operating in the euro area, which account for around 85% of euro area banking assets.

The assessment will involve a Balance Sheet Assessment including an Asset Quality Review to be conducted by the ECB. This will then feed into the overall stress test to be conducted by EBA, in cooperation with the ECB. The results of both exercises should be ready before we start actually supervising the banks next year.

We want this assessment to be as rigorous as possible. Consequently, we are prepared for the fact that it may reveal capital needs. If so, the first responsibility is for banks to raise capital themselves. But there may be a public dimension as well, which is why the European Council on 27–28 June addressed the need for backstops to be in place before the exercise is completed. Without these financial backstops being in place the ECB does not advice to complete the whole set of balance sheet assessment and stress tests.

However, investors will not be fully confident in the euro area unless they believe that banks can fail without causing financial instability. Otherwise, they will expect supervisors to practice forbearance.

This is why the SSM needs to be accompanied by a Single Resolution Mechanism.

The European Commission announced last Wednesday a proposal for a Single Resolution Mechanism based on the concept of a an agency with wide of autonomy and ultimately dependent on the Commission for the crucial decision of putting a bank into resolution. Different alternative institutional setups could be conceived but the existence of a SRM is a key priority for Europe and I am very pleased to see in the proposal that the envisaged timeline takes this into account, with the entry into force foreseen for mid-2014 and operations commencing in January 2015. This aligns with the entry into force in 2015 of the new legal framework for resolution in Europe, the Bank Recovery and Resolution Directive (BRRD), which will provide a harmonised framework of resolution powers and tools.

While it is still too early to provide an in-depth assessment of the Commission proposal and a more detailed assessment will be published in our ECB legal opinion, I would like to welcome, from a personal point of view, some important points contained in the Commission's proposal. First, the Authority will have the capacity for truly European decision-making with no veto powers for national authorities. In my view this is key for dealing swiftly and impartially with large cross-border banks, although the proposal appropriately applies to all banks of the participating countries in the Single Supervisory Mechanism, thus ensuring a cohesive system.

Second, the Authority would own a Single Resolution Fund which would be financed by *ex ante* risk based contributions to be complemented *by ex post* contributions both paid inby the industry. Although not specified, the proposal stipulates that the Fund would be able to borrow from both private and public alternative funding means. These borrowings would subsequently recouped from the industry, thus ensuring fiscal neutrality in the medium-term. I would have preferred, however, that the proposal would have considered explicitly the issue of a public backstop for the resolution fund in the form of a credit line that would have to be repaid afterwards, as it is the case with the US FDIC.

The ECB has strongly advocated for an SRM comprising of these three elements: a single system, a single authority, and a single fund. The proposal contains these three elements and consequently reduces the harmful effects of sovereign-bank interactions by diminishing the importance of implicit sovereign guarantees.

The SRM will operate in the legal framework established by the Bank Recovery and Resolution Directive (BRRD), which was recently agreed by Member States' Governments. This Directive foresees that bail-in becomes the first line of defence in dealing with banking crisis – indeed, 8% of liabilities will have to be bailed-in before resolution funds or other public funds can be used, with depositors of persons and SME being given the highest preference. Nevertheless, the full bail-in tools that includes the possibility of burning senior bank bonds and uninsured deposits will entry into force only at the end of 2018. Before that date only shareholders capital and subordinated debt can be used to resolve a bank. Insured deposits, secured borrowing (including repos and covered bonds) are exempt from bail-in. I think that the bail-in principles approved by the Member States and the respective timeline until 2018 are appropriate to allow a transition period that is helpful to ensure stability in the bank bond market.

This new rules should support the work of the SSM by strengthening incentives in the financial sector to exercise market discipline on problematic banks.

To sum up, the euro area banking sector is becoming more stable overall, and given the euro area's central role in global financial intermediation, this creates positive spillovers for the global economy. Banking Union will take this process forward by increasing confidence in supervision and ensuring that banks that need to be wound down, can be. To the extent that this supports credit growth to the private sector, this will also generate higher growth in the euro area and help the global economy through that channel, too.

Conclusion

Let me now conclude.

Advanced economies, Europe in particular, face a long period of slow growth that will test the quality of our institutions. The European social compact will have to prove its adaptability and resilience. The Euro Area is still facing a painful crisis of imbalances, financial fragmentation and low growth. Questions of excess inequalities and high unemployment will have to be addressed.

Meanwhile the world will continue to march towards the Great Convergence cogently described by Kishore Mahbubani in his latest book.

To fulfil its role in the process, Europe is addressing its structural problems which have been holding back growth and at the same time it is ensuring that its banking sector contributes to global stability and growth. Europe is undertaking a process of wide and deep reforms, of which the Banking Union project is a major example, that will ensure a future healthier path of economic progress.

As someone said, "a crisis is a terrible thing to waste" – and we are using this crisis to build a stronger and more stable monetary union that will play a constructive part in global rebalancing.

Thank you for your attention.