Yves Mersch: The overhaul of the architecture of the euro area and the return of investor confidence

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the CFA Institute European Investment Conference "Beyond austerity – opportunities for European investors in the global market", London, 15 November 2013.

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Introduction

It is a great pleasure to join you at the Sixth Annual European Investment Conference and to have this opportunity to talk to investment professionals. I would like to discuss the return of confidence in the euro that we have observed over the past year. In particular, I would like to show that recent financial market developments confirm the credibility of the reform actions taken at European and national level. We can clearly see that investor confidence is slowly returning, that the persistent euro area financial market fragmentation is decreasing and that contagion is receding. This does not mean that the euro area and its member countries can rest on their laurels, as some efforts are still needed to bring an end to the crisis and to put Economic and Monetary Union (EMU) on a stronger footing.

Building a stronger EMU

Before looking at these encouraging market developments, let me briefly recall the causes of the euro area crisis and the policy actions taken at European and national level to address the economic imbalances and financial vulnerabilities.

As the crisis has shown us*:* the original design of the euro has been incomplete. It became clear that the euro area lacked certain institutional elements which are essential to federations with a single currency. Three of these shortcomings were particularly acute and contributed to the euro area sovereign debt crisis:

First, the Maastricht Treaty was a child of its time. It reflected the ambient overreliance on the disciplinary effects of markets. Fiscal policies remained at national level. The Stability and Growth Pact provided rules to mitigate this situation but their implementation by the Council of Ministers often lacked traction and facilitated fiscal indiscipline.

Second, macroeconomic imbalances often precede fiscal disequilibria. But the Treaty only provided for a vague coordination of economic policies which on top were not determinedly pushed by the Commission.

Third, Europe lacked a coherent approach to financial sector policies. Regulatory frameworks and financial policies remained insufficiently harmonised and centralised, neglecting the increasing level of financial integration in the euro area. In this respect, there was no level playing field for European banks and, in particular, there was no institutional framework to deal with (domestic and cross-border) systemic risks in the banking sector. To be true, in the late 80s/ early 90s the concept of systemic risk hardly existed.

The flaws of the original Treaty are therefore less of a conceptual nature – unless one applies the intellectual framework of today with the benefit of hindsight to judge the design of the early 90s. The main flaw in my view was that the political authorities and economic agents did not internalise enough what participation in a monetary union means. They received the benefits of reduced interest rates but missed out on the obligations for the country itself (i.e. the need for adjustment through the domestic economy) and towards other countries (arising from negative spillovers linked to unbalanced domestic policies). A coherent and viable architecture of EMU ought to be based on more integrated frameworks for budgetary matters, economic policy, financial sector and democratic accountability.

In light of the crisis and the urgent responses it required in the short term, one may lose sight of the major institutional progress achieved since the crisis erupted. Besides putting in place crisis management tools and financial firewalls that not only proved effective but also underlined a degree of solidarity unseen before to accompany ambitious reform programs which began – where implemented – to yield results, European leaders have adopted major decisions aimed at significantly reinforcing the architecture of EMU.

First, the fiscal framework has been strengthened since the start of the crisis to improve fiscal discipline and restore fiscal sustainability in euro area Member States. In particular, fiscal surveillance has been enlarged and fiscal governance has been enhanced by procedural steps to nearly automatic sanctions. We expect that no further holes will be punctured in this strengthened SGP.

There are encouraging signs. National governments are addressing their fiscal imbalances. The euro area's progress in fiscal consolidation is much more advanced than that of other regions of the world. Its average fiscal deficit in 2013 is projected to be 3.1% of GDP, compared with a 5.8% deficit in the US or a 9.5% deficit in Japan. Gross general government debt is expected to peak at 96% of GDP in the euro area this year vs. 106% in the US and 244% in Japan.

Second, economic governance at European level has been improved by implementing the Macroeconomic Imbalance Procedure (MIP). The MIP has been set up to enhance surveillance, identify potential risks and correct existing imbalances. This has been complemented by structural reforms which have been introduced at national level to address the serious gaps in competitiveness. This new procedure should be pursued with determination by the Commission to lend it much needed credibility.

And again, things are moving in the right direction. The competitiveness gaps in the euro area have been partly corrected largely on account of declines in unit labour costs in many stressed euro area countries. Current accounts in these countries have improved substantially and a significant part of this adjustment is considered to be of a non-cyclical nature and therefore likely to be sustained in the medium term. Some larger countries, however, are slow on structural reform. They should be aware of their responsibility for the euro area as a whole.

Finally, the establishment of a banking union has been agreed and is now being delivered in stages, starting with the Single Supervisory Mechanism (SSM). The creation of the SSM will ensure effective supervision and a level playing field for euro area banks across countries, which needs to be commensurate with the high level of banking integration in Europe***.***

On 23 October, we announced the details of the comprehensive assessment that we will undertake in the run-up to the SSM***.*** This assessment will include three components. The first one is a supervisory risk assessment that will address key risks in the banks' balance sheets, including liquidity, leverage and funding. The second component is the asset quality review that will look at credit exposures, on- and off-balance sheet positions and domestic and non-domestic exposures. The third component is the stress test that will build on and complement the asset quality review by providing a forward-looking view of banks' shock-absorption capacity under stress.

As a second, indispensable pillar of the Banking Union, the SSM will need to be complemented by a single resolution mechanism (SRM). Once the single supervisory mechanism is operational and supervision is passed to the European level, the same needs to happen for resolution. Therefore we strongly support the envisaged timeline for the SRM to become effective in January 2015.

In sum, the euro area is actively moving in the direction of a more robust and safer financial sector within the context of a strengthened monetary union.

The return of confidence

The credibility of these policies and actions at national and supranational level and the return of confidence in the euro is demonstrated by three recent positive developments in the euro area financial markets. First, the substantial capital inflows to the euro area in recent months. Second, the receding financial fragmentation across various euro area market segments. And, finally, the limited contagion from adverse news compared with earlier stages of the euro area crisis.

Financial market fragmentation

Similar to the positive developments in international capital flows, financial market fragmentation has declined over the past year.

First and foremost, intra-euro area bond spreads have narrowed sharply and, as a result, borrowing costs for euro area governments have returned to more sustainable levels. Ireland's 10-year government bond is cheaper than before the sovereign debt crisis. As a consequence the Irish government has decided to exit the program even without a precautionary safety net.

Receding financial market fragmentation has not been confined to government bond markets. Increased investor sentiment was also transmitted to other market segments. In particular, the dispersion in the cost of debt issuance across euro area banks has been reduced, coupled with improved funding and market access for banks in stressed euro area countries. Moreover, non-financial corporate bond spreads in the euro area have also followed a continuous downward trend. Finally, fragmentation in euro money markets has also receded. The on-going advance repayments of funds borrowed from the ECB under the three-year LTROs is also a sign of receding tensions in funding markets.

Now that financial fragmentation has been receding on the funding side of the banks, a key challenge remains in alleviating fragmentation on the lending side of the banks, especially towards stressed countries and towards SMEs.

Financial market contagion

Finally, the return of confidence in the euro is reflected in the increased resilience of the euro area financial environment to adverse political news and to heightened global market volatility.

Let me give two examples. The first refers to euro area country-specific instabilities. The second refers to heightened levels of global risk aversion.

At earlier stages of the euro area crisis, euro area country-specific policy uncertainty was immediately transmitted to other countries under stress. Even more so, intra-euro area sovereign spreads increased disproportionately as investors rebalanced into euro area economies perceived as safe havens.

However, an over-reaction of sovereign bond markets in stressed euro area countries has not been observed in recent months. Following adverse euro area country-specific news, such as the instability in Cyprus in early 2013 or the recent political tensions in Italy and Portugal, contagion to other euro area countries has been limited.

The second example refers to the recent bout of global financial market volatility. The period served as a useful initial stress test for vulnerabilities in certain global market segments.

Again, bond and equity markets in stressed euro area countries have been remarkably resilient to the heightened global risk aversion. Capital outflows were modest and the increase in yields marginal. By contrast, several emerging market economies experienced significant disruptions and were subject to pronounced portfolio retrenchment by global investors. Investors seem to increasingly differentiate between securities of stressed euro area countries on the one hand and other riskier market segments on the other hand, which have been subject to capital outflows amid elevated levels of risk aversion.

Taken together, the return of foreign investors, receding financial market fragmentation and a halting of contagion clearly demonstrate a return to confidence in the euro, and the credibility of the measures taken at supra-national and national level.

Let me now conclude. The euro area crisis has painfully shown that the original design of the monetary union was incomplete. An overhaul of the EMU architecture was necessary and a lot of progress has been made over recent years to strengthen EMU, both at national and at supranational level.

And we are now seeing encouraging signs. Recent financial market developments clearly demonstrate the credibility of the reform measures taken at European and national level – although progress is unevenly distributed. Investor confidence is returning, the persistent euro area financial market fragmentation is decreasing and contagion is receding.

However, the policy agenda needs to be completed. Investment has taken a disproportionate share in the adjustment process and must be freed.

Financing the real economy via the banking channel should resume with the certainty and confidence accompanying the Banking Union's comprehensive assessment.

Capital markets reform needs to be backed properly by regulation.

Indeed, as Churchill famously said: Continuous effort is the key to unlocking our potential.