Yves Mersch: Mastering the crux of defragmentation

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the SAFE (Sustainable Architecture for Finance in Europe) Conference on Financial Market Policy, Goethe University Frankfurt, Frankfurt am Main, 29 November 2013.

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Ladies and gentlemen,

A key feature of the crisis was the fragmentation in financial markets in the euro area. The challenge of reversing this fragmentation is therefore a major crux on the climb out of crisis.

Mountaineers would usually expect the crux of a climb to be somewhere close to the summit of the mountain. So what makes the situation of the euro area at this early point of the climb a crux? In my view there are two particular features of a crux: First, a crux is a difficult passage of the climb with various pitfalls that the mountaineer must master in order to arrive to the summit. If the climber cannot pass the crux, she or he must take a long and exhausting detour. The second feature of a crux is that it is situated in exposed terrain. Hence, the climber has to take appropriate safeguards and rope up to reduce the risk of an accident.

The process of defragmentation

As a first encouraging step forward in the climb out of the crisis, we see that fragmentation of financial markets in the euro area has come down significantly since its climax in the early summer of 2012. Deposits have grown, capital inflows have taken place, the claims on the Eurosystem by banks continue to go down and TARGET2 balances have declined. Euro redenomination risks have been taken off the table.[1] Euro area banks – also those in non-core countries and smaller institutions – have reported to the ECB a continuing improvement across funding categories in the third quarter of 2013.

This process of receding fragmentation of financial markets I want to refer to as defragmentation. Defragmentation does not happen overnight. It proceeds gradually, supported by lower risk aversion, and requires time to feed through to the financial system and, finally, to the real economy. For example, we observe that bank loans to businesses are still subdued. Based on historical experience, we know that bank loans are one of the last financial indicators to pick up in a recovery. In the initial phase of the recovery, firms normally make use of internal or market-based sources of funding rather than banks.

I will now focus on the first feature of the crux, the pitfalls on the climb towards recovery. I see three main pitfalls that may slow down the process of defragmentation or even reverse it:

- competitiveness differentials across Member States,
- public and private deleveraging, and
- institutional barriers in financial markets.

In the following I would like to address each of the pitfalls one by one.

Competitiveness differentials across Member States

Competitiveness differentials within the euro area – but also globally – are a challenge because they can lead to macroeconomic imbalances. The recent crisis has taught us a

[1] Al-Eyd, A. and Berkmen, S. P. (2013). Fragmentation and Monetary Policy in the Euro Area, IMF Working Paper WP/13/208.

lesson how imbalances can put financial stability at risk. Therefore, it is important that existing imbalances are corrected.

In this respect I see remarkable progress in some areas. All periphery countries have recaptured some of the losses in competitiveness that had been incurred previously. There is no single best indicator of competitiveness, as there are many dimensions to this concept relating to both price and non-price factors. This notwithstanding, nominal unit labour cost developments provide a good indication of the extent to which an economy can effectively compete in terms of labour costs.

But we should also focus on institutional competitiveness, that is to say the quality of governance, the cutting of red tape and efficiency of tax systems. These aspects have also formed part of the adjustment programmes that some countries are going through.

Overall, it is important to realise that one reason for the need to implement adjustment measures was a lack of action in the time before the crisis. It is not "austerity" that leads to weak growth, but structural weaknesses and low growth potentials caused the need for consolidation.[2]

Meanwhile we can see encouraging signs that these measures are bearing fruit. Stressed countries such as Ireland, Spain or Portugal – but also other euro area countries – have shown significant current account improvements. Greece has improved its current account position by over 14 percentage points since 2008. At first, only imports decreased but lately also exports have grown.

Those countries that have reformed are being rewarded twofold: by their own success and the solidarity and support by the European community.

As a result, imbalances within the euro area have decreased. Hence, the financial stability risks emerging from imbalances have also receded. And stressed countries have a much better and more sustainable growth perspective than some years ago. All this has important confidence effects on investors and encourages them to return to these markets. This in turn supports defragmentation in the euro area. Indeed, this analysis is shared by international investors as substantial capital inflows to the euro area in recent months show. In October, annual net capital inflows of 322 bn Euros were observed, mainly driven by current account surpluses and an increased weight on euro area equities and securities, including from stressed countries.

At the same time, I want to note our efforts to reduce competitiveness differentials should not lead to a loss of competitiveness of the euro area as a whole. Competitors elsewhere in the world are not sleeping. The model of the euro area is to match the best rather than converging to the average. So far we are on the right track. Since the start of the financial crisis, the aggregate euro area current account has reversed from a deficit of 1.9% of GDP in the third quarter of 2008 to a surplus of 2.4% in the second quarter of 2013 – the highest since the introduction of the single currency. This being said, the euro area should also strengthen its domestic business investments. It is not only about exporting but also about investing in the technology and equipment that will deliver competitive advantages in the future.

Public and private deleveraging

Let me now turn to the second pitfall in the process of defragmentation: public and private deleveraging. Many euro area Member States are emerging from the crisis with high public and private debt levels. Persistently high debt levels could severely delay the process of defragmentation. At the moment, deleveraging is underway with varying progress. To be

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[2] Bini Smaghi, L. (2013). Austerity and stupidity, VoxEU.org.

more precise, let me take a closer look at different sectors of the economy: The public sector, the financial sector and the non-financial sector.

In the public sector, gradual and continuous deleveraging has taken hold. The euro area has the lowest budget deficits and debt levels of the large advanced economies in the world.[3] Moreover, the divergence within the euro area has been reduced. At the European level, mechanisms that ensure public deleveraging have been strengthened. In the field of public finances, the euro area is on track. What we need now is persistence and patience. If governments fail to deliver in the deleveraging process, defragmentation could easily be slowed down or even reversed.

In the financial sector, balance sheet adjustments have also started. In many Member States impaired assets have been transferred to asset management companies. Nevertheless, confidence in the health of bank balance sheets has not yet been fully restored. In the run-up to the SSM, the ECB will conduct a Comprehensive Assessment of banks' balance sheets. This assessment will increase transparency by enhancing the quality of information that is available concerning the conditions of banks. It will also identify weaknesses and entail corrective actions where necessary. It will therefore also play a pivotal role in displaying the progress of financial sector deleveraging. The Comprehensive Assessment will hence further support defragmentation.

Deleveraging in the non-financial sector has so far been less discussed. *The Economist* has recently termed this issue "the other debt crisis". In particular in stressed countries, businesses suffer from high debt levels. For profitable businesses this can lead to a debt overhang which inhibits them from financing new and value creating investment projects. For unprofitable businesses, the question is even more unfortunate from a macroeconomic perspective: The capital bound in such undertakings could probably be put to a more profitable use elsewhere.

Of course, deleveraging itself will consume profits and capital and weigh on economic activity for some time. We are still in a phase of disappointing growth dynamics of broad money, and loans to non-financial firms are only stabilising at weak levels.

But it is important to deleverage in order to allow capital and labour to reallocate. Schumpeter once told his students in a university lecture that a depression is for capitalism like a good, cold shower. I would not go as far as him, because the economic adjustment in a crisis is much more painful than a cold shower. But it is true that we must seize the opportunities that our current situation offers. We must avoid the pitfall of being complacent with high debt levels that will prolong fragmentation and ultimately hamper growth.

Institutional barriers between financial markets

And with this I would like to turn to the last of the three pitfalls that I listed at the outset. I believe that institutional barriers between national financial markets remain one of the key pitfalls in the quest to secure defragmentation.

In the crisis the institutional responsibility for dealing with bank problems was exclusively with the individual EU countries. In some cases, as in Ireland, the problems of domestic banks overwhelmed the fiscal capacity of the sovereign. In other cases fiscal problems have dragged down the banking system. The result was the well-known vicious feedback loop between banks and sovereigns. In addition, the incentives of national supervisors were often not aligned with the European financial stability objective. Some supervisors, motivated by uncertainty, engaged in defensive actions such as national ring-fencing of liquidity and

[3] Comparison of US, Japan and euro area. See European Commission (2013), European Economic Forecast Autumn 2013.

national asset-liability matching. This may have been rational given their mandates, but it reinforced fragmentation of financial markets.

With these remarks on the three pitfalls competitiveness, deleveraging and institutional barriers, I would like to turn to the second feature of a crux: The need to take appropriate safeguards to avoid an accident. Edward Whymper, the first climber of the Matterhorn in Switzerland, once recalled that “courage and strength are nought without prudence”. In a fragile situation as in these days the euro area must indeed act very prudently and not overestimate its strength. Concretely, this means to take precautions that fragmentation does not return.

Banking Union

One very important precaution is currently in the making: The Banking Union. It will encompass the euro area as well as other EU Member States that may wish to participate. In our opinion, two elements of the Banking Union are key: a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM). Both elements will be discussed in more depth in two of the panel discussions later on. At this point I would like to limit myself to pointing out three success factors that these two mechanisms should count with to ensure further defragmentation in the euro area. In the case of the SSM we already know that these success factors are by and large fulfilled. For the SRM this will depend on the final outcome of the legislative process.

The first success factor is *common access to information*. Both SSM and SRM will have access to the relevant information of all banking institutions in participating Member States within their field of competence, ranging from full-scale supervisory information for the SSM, to resolution plans for the SRM. This way both mechanisms can ensure comparability of information across national borders and have a sound basis for their actions.

The second success factor is *common decision-making at the European level*. Both mechanisms have a single European decision-making body: the Supervisory Board prepares the supervisory decisions to be decided by the Governing Council in the SSM and the Single Resolution Board prepares the resolution decisions to be taken by the European Commission, if we consider the proposal currently on the table. As a result, and even if we have changes in the SRM, it is key that we remain in each of the mechanism with a single body at the European level that will be ultimately responsible for decision-making.

The third factor is *common tools*: Both SSM and SRM will have their respective single tool box to achieve their mandates. For the SSM this refers to the harmonised supervisory powers of the Single Rulebook provided for by the CRDIV/CRR, even though the many options and prudential filters at national level with phasing-in allowed in some cases until 2029 need to be addressed. In addition, the SSM will make use of a Supervisory Manual to ensure harmonised supervisory practices across participating Member States. In the case of the SRM the harmonisation of resolution tools is provided for by the Bank Recovery and Resolution Directive. In its resolution activity, the SRM is foreseen to have access to a Single Resolution Fund, which should be financed by the industry itself. Therefore, it is essential that discretion – when it is required for objective reasons – ought to be applied at the central level. Otherwise there is the risk of re-fragmentation under the pretext of national particularities.

If these three success factors are put in place, the Banking Union can achieve its long-term objective: to create a single financial market. This would enable a creditworthy firm or household to get a loan from any bank in the Union at comparable conditions – and location considerations would not be predominant. In this way Banking Union is a central safeguard against fragmentation.

Banking Union will also be pivotal for the smooth functioning of Monetary Union because it will help to repair the monetary policy transmission mechanism. However, progress on the other three pillars to accompany Monetary and Banking Union – fiscal, economic and political union – is also needed.

Establishing the SSM

I would like to use the opportunity to address in more detail two issues related to the establishment of the SSM.

As mentioned before the ECB will conduct a comprehensive assessment of banks' balance sheets before officially taking up the new supervisory task. This exercise will include three components. The first is a supervisory risk assessment addressing key risks in the banks' balance sheets, including liquidity, leverage and funding. The second is the asset quality review that will assess credit exposures, on- and off-balance sheet positions and domestic/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.

This process has already started. After a pilot phase during which the ECB called for – and subsequently integrated – feedback from the banks, the ECB recently sent out the templates for data collection.

In this context, let me also touch upon the treatment of sovereign credit risk in the comprehensive assessment. In line with the current legal situation in CRDIV/CRR the point-in-time balance sheet assessment will apply a "zero risk" weighting for banks' sovereign debt holdings. However, in the medium term it makes sense from a prudential point of view that assets are being weighted according to their riskiness and not according to conventions which might not reflect reality. This should however be done in a coordinated fashion at international level by the relevant competent forum, the Basel Committee for Banking Supervision, which has acknowledged this common sense principle but allowed for exceptions at the local level, which were exercised in the EU.

The second issue that I wanted to bring up in the context of the establishment of the SSM is the separation of monetary policy and supervision. Starting next autumn, both monetary policy and banking supervision in the euro area will fall within the remit of the ECB. This situation brings several possible conflicts of interest between supervision and monetary policy. The discussion on these possible conflicts is sometimes somewhat blurred. Therefore, let me be clear on what these possible conflicts may entail:

First, a banking supervisor may have an incentive to delay or avert an interest rate decision of the central bank in order to disguise interest rate risks on banks' balance sheets or to prevent those risks from materialising.

Second, the banking supervisor may want to send an unviable bank into resolution which has large amounts of outstanding central bank borrowings. In this situation, the central bank may have an incentive to delay or object to the resolution of this bank to avoid a default on the outstanding monetary policy operations. Of course, all Eurosystem credit operations are collateralised but the resolution of collateral can be a lengthy process and a residual risk can never be fully excluded. Let me add that looking back the ECB has not lost a single cent.

The ECB will put the necessary measures in place to avoid these conflicts and ensure separation of monetary policy and supervision. Many of these measures are already codified in the SSM Regulation which serves as legal basis for the set-up of the SSM. Allow me to outline a few of them.

Most importantly, the planning and execution of supervisory tasks will be conducted by a separate body, the Supervisory Board. The Supervisory Board also prepares the draft decisions that are presented to the ECB Governing Council. The Governing Council's deliberations on supervisory matters will be strictly separated, including separate agendas and meetings. A mediation panel will be set up and resolve possible differences regarding an objection of the Governing Council to a draft decision by the Supervisory Board.

Furthermore, the SSM will also have its own accountability procedures towards the European Parliament, the Council and national parliaments. Accountability will be rendered by the Chair of the SSM's Supervisory Board and not by the ECB's President. This is intended to avoid any confusion among the two sets of roles and to safeguard the ECB's independence.

In addition, the staff involved in carrying out supervisory tasks will be organised in separate Directorate Generals and be located in a different building once the staff responsible for monetary policy has moved to the new ECB premises.

Conclusions

Ladies and gentlemen,

The euro area is early on in the climb out of the crisis. The summit is still far and covered in fog. And the euro area has to master the crux of defragmentation. Evident pitfalls are between us and the rewarding view from the mountain top. These pitfalls are competitiveness, deleveraging and institutional barriers. But at the same time I believe we are on the right track. If we act prudently and put in place the necessary safeguards, this crux before us is manageable. In this regard, the establishment of Banking Union represents an exceptional opportunity that will support further defragmentation and ensure financial stability in Europe.

Thank you very much.