Erkki Liikanen: Ensuring economic and financial stability in Europe

Keynote address by Mr Erkki Liikanen, Governor of the Bank of Finland and Chairman of the High-level Expert Group on reforming the structure of the EU banking sector, at the European Conference at Harvard University, Boston, 1 March 2014.

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Deputy Prime minister of Croatia spoke a moment ago about the recent entry of his country into the EU as the 28th member. Exactly twenty years ago, on 1st of March 1994, accession negotiations of Finland, Sweden and Austria were concluded, and the countries soon joined as the 13th, 14th and 15th member states. So much has happened during these 20 years, not least in the EU integration.

About a month ago, Strobe Talbott wrote an article for the New York Times about the state of European integration. In that excellent piece, he evoked the contribution of Jean Monnet, one of the founding fathers of the EU.

Talbott's point was that the Europeans need to recall Monnet's idea of institution-building as the only durable method of integration. "Nothing is possible without men, but nothing lasts without institutions", he said. Talbott linked Monnet's dictum to the present stage in the deepening of the integration, that is, the building of the Banking Union.

As you all know, Jean Monnet was son of a cognac entrepreneur who later became a top civil servant in France and at the League of Nations. In 1952, he became the first president of the European Coal and Steel Community, from which the present European Union has developed.

During most of the Second World War Monnet worked in the U.S. He was involved in many international diplomatic operations during the war, with the confident backing of President Roosevelt.

I just want to mention two episodes in Monnet's career. First I shall relate a historical episode from Monnet's wartime activities, which starts his memoirs. In June 1940, the French government was wavering between continuing the war and ceasing hostilities. Monnet was in London at the time, doing his utmost to encourage the French government to continue the war. Monnet proposed that the British government should do something dramatic to galvanize the French government.

Monnet's solution was to create a political union between England and France. The union would have a common currency and joint citizenship. It would also include a customs union. Winston Churchill hesitated, but forwarded the proposal for his cabinet to discuss. To his surprise, the British government received the proposal enthusiastically and approved it on 16 June 1940. The plan was also supported by the French Prime Minister Reynaud, who was unable to convince his cabinet and resigned. Petain came into power. France was lost.

The second episode relates to the year 1950.

We are here in the middle of the Massachusetts winter. Winter sports seem to unite many of us, here in Boston and in Finland. We have even a same asset in ice hockey, the goal-keeper Tuukka Rask, of the Boston Bruins and of the national team of Finland. Winter and skiing meant a lot for Jean Monnet, too. Monnet wrote his great proposal of the European Coal and Steel Union during a two-week cross country skiing holiday on the Alps in the winter of 1950. He made his skiing trip alone, with only a guide helping him to find his way.

European integration can only be understood against its historical background and especially the two world wars. The Community was founded on the necessity of ending the historical antagonisms between the great European powers.

Jean Monnet stressed that there could be no peace in Europe, if states continued to be structured around the sort of national sovereignty that leads to politics of privilege and economic protectionism.

This thinking was certainly shared by many other European politicians. One of them was J.K. Paasikivi, the Finnish banker and diplomat, and later the President of Finland. In the summer of 1944, Mr. Paasikivi wrote in his diary about the fate of small countries. His reading of history had made him a pessimist: “States act according to the raison d’état, only in the national interest. It is frightening, blood-red.”

He went on: “Solving the problem of limiting the raison d’état and its relationship to morality is an issue that, although primarily affecting the future of small countries, will ultimately also determine the future of larger countries and the whole of mankind.”

This rather grim background goes a long way in explaining the European approach to integration. The emphasis has been on agreeing on common rules building EU law. The member states have been willing to commit to joint rules which protect members from negative externalities of each other’s policy actions. But they have been cautious in delegating executive power to the EU institutions.

This is evidenced, for example, by the fact that the EU budget is small in relation to the member states’ budgets, but the states have instead agreed on binding rules and surveillance which limits their fiscal policies.

The EU has often been contrasted with the U.S. One of the differences is that whereas the U.S. has its Constitution, which was signed more than two centuries ago and has been remarkably stable ever since, the European approach to integration is evolutionary and gradual. This reflects political realities. The EU is not a country, but a unique union of nation states.

The development of the EU reflects more the concrete challenges faced on the path of integration than any political theories. For better or worse, the union has moved forward as a result of successive crises which have always prompted the next reform.

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The last crisis has prompted extensive changes in the governance of the EU and especially the euro area.

The crisis exposed two major weaknesses in the euro area policy framework. The first is that the combination of integrated monetary policy, run by the ECB, and leaving economic policies at the member state level proved to be too weak an arrangement.

Despite the stability and growth pact of 1997, which was meant to guarantee the sustainability of member countries’ finances, fiscal discipline among the member countries was not strong enough. Nor was the discipline enforced by the market, which did not care very much about the growing indebtedness of some of the countries, until the crisis struck. Then, of course, there was a sharp backlash and even an overreaction.

The other weakness which was exposed by the crisis had to do with banking regulation. Despite of the single banking market and a common currency, banking supervision had been left on a national basis. Moreover, even the national authorities did not have adequate resolution powers in the way the American FDIC has, for example.

The crisis started an unprecedented and bold reform of both the macroeconomic policy framework and the way banking supervision and resolution are organized.

Let us consider the fiscal side first.

The fiscal and economic policy framework has been strengthened. This has partly been done by two sets of new EU legal acts, which are nicknamed the “six-pack” and the “two-pack”. The new legal acts make the budgetary and macroeconomic surveillance mechanisms much more effective. By these acts, after the experience of the crisis, some more power has now been delegated to the Commission.

Furthermore, the members signed the so called Fiscal Compact. This is an intergovernmental treaty whereby the members committed to include certain balanced-budget rules in their national legislation "through provisions of binding force and permanent character". The pact does not require a budget balance at all times but instead calls for a rapid adjustment towards the medium-term objective.

The crisis also forced the member countries to reconsider banking regulation and supervision arrangements. Their weakness had been a subject of quite active discussion ever since the decision to form a monetary union was reached in December 1991 at Maastricht in the Netherlands. However, the resistance to surrendering national sovereignty on banking supervision proved too strong in an environment where serious banking crises were not expected and – even more importantly – the cross-border effects of banking problems were seriously underestimated.

However, the crisis proved that the fragility of banks can be just as detrimental to the functioning of a monetary union as excessive government deficits. The reason is that if banks are weak, a link shows up between government creditworthiness and the state of the banks.

For example, in some countries government finances were superficially in order, but during the crisis problems in their overextended banking sectors soon damaged government finances as well, with very serious consequences. A so called doom loop emerged, with problems in systemically important banks hurting government finances, and deteriorating government finances in turn hurting the creditworthiness of the banks (because of the too-big-to-save –phenomenon).

The operation of this "doom loop" caused instability in the euro area money and capital markets, which even threatened the unity of the single monetary policy and the currency area. The ECB managed successfully to stabilize the situation in the summer of 2012 by announcing its readiness to defend the unity of the euro area with "whatever it takes".

It was clear, however, that structural reform was needed in order to remedy the situation in the long term. It was as a reaction to this challenge that the EU launched its project of a Banking Union, of which some components are already in the process of being implemented while others are still in preparation. The idea is to break the bank-sovereign nexus, cut the "doom loop" and thereby make the single currency area more resilient both to banking problems and to fiscal problems, should they emerge in the future.

The Banking Union has three components.

The first is the Single Supervisory Mechanism. The ECB will be given the ultimate responsibility and powers to supervise all euro area banks. The largest banks will be under direct ECB supervision while national supervisory authorities will act as agents of the ECB in the supervision of smaller banks. The creation of the Single Supervisory Mechanism is well under way and it will start operations in November this year.

The transition to the Banking Union will be preceded by a review, the so-called "comprehensive assessment" of the euro area banking system in order to ensure that banks which come under the ECB supervision are adequately capitalized.

The second component is the new bank recovery and resolution framework. It will give the authorities early intervention powers which make it possible to take decisive action in problem banks before the banks' own funds are exhausted. The framework will also give authorities new bail-in powers which should ensure that the taxpayer is only the last in line to recapitalize banks and normally not needed at all.

In addition to the new harmonized rules on bank resolution, Europe also needs a unified resolution authority, called the Single Resolution Mechanism, with access to a Resolution Fund. The design of these institutions is under intensive negotiation. Most likely they will start as an intergovernmental structure but the EU community elements will be reinforced over time.

The third component of the Banking Union, in addition to single supervision and single resolution mechanisms, will be the harmonization of deposit insurance systems.

I should mention yet another reform in the area of banking, regarding the structure of banks and the regulation of proprietary trading.

A month ago, the European Commission presented a legislative proposal which, if enacted, will give the authorities powers and under some conditions also an obligation to require of banking groups the separation of the riskiest trading activities from deposit banks. In the euro area, the competent authority will be the ECB. This proposal for structural regulation follows, at least partly, the recommendations of the EU expert group which I chaired and which submitted its report about a year and a half ago.

The Commission's legislative proposal would also include an outright prohibition of proprietary trading, resembling the U.S. Volcker rule.

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The institutional developments which I have reviewed were not mainly directed towards managing the recent crisis, which fortunately seems to be gradually abating in Europe. They are meant to prevent future crises, to avoid the repetition of the painful experiences of the last five years. But the reforms have served a purpose also in the present situation. They have contributed to the restoration of confidence in the financial markets so that tensions in the bond market, which peaked in 2011 and 2012, have reduced and the interest rate spreads between the highly indebted countries vis-à-vis the rest have narrowed.

The positive news is that the necessary financial adjustment in the euro area is now well under way. However, as we know, leveraging is fast and deleveraging is slow, so the process will take time. We can also see that competitiveness in the former deficit countries is improving. The current account deficits of the Southern European countries, as a whole, which were at unsustainable levels three years ago, have now vanished and turned into surpluses, so that these countries are no longer dependent on external financing. Also their budget deficits are shrinking. High unemployment remains, however, the biggest problem.

Due to the real adjustment which has taken place, and also due to the action taken by the ECB, the market conditions in the euro area have generally improved. Not only have interest rate spreads narrowed but also funding conditions have become better.

I want to conclude by saying that the institutional and legislative changes which have been taken in response to the recent crisis represent a major and real step forward in European integration.

The legislative and institutional achievements of the crisis years have not come easily. They are the result of a process which has tested the patience of the citizens and the financial markets alike. The crisis, and the enormous tensions which were created by the diverging financial situations of the member countries, created a climate where all initiatives to surrender national sovereignty were politically very difficult. But this makes the achieved progress all the more impressive, as it demonstrates how strong the underlying commitment to the practice and idea of European integration still is, more than 60 years after Jean Monnet was drafting the plans for the European Coal and Steel Community.