

Vítor Constâncio: Reflections on financial integration and stability

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the Joint ECB-EC Conference on “Financial Integration and Stability in a New Financial Architecture”, Frankfurt am Main, 28 April 2014.

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Ladies and gentlemen,

Dear colleagues and friends,

It is indeed a pleasure to participate in this joint presentation of two important policy reports: the European Commission’s *European financial stability and integration report 2013* and the ECB’s *Financial integration in Europe 2014* report.

Both studies illustrate that some steady, albeit uneven, progress is being made towards financial stabilisation. Banks are reducing their liquidity buffers, repaying our LTROs and regaining confidence from the markets. Money market integration is slowly improving, particularly in the secured segment. Quantity-based indicators confirm a stabilisation in bond markets and improved integration in equity markets. Given where we stood barely two years ago – on the edge of redenomination risks – such progress is encouraging. However, it does not mean we are entirely out of the danger zone.

If we look at banking markets, there is still a large dispersion of borrowing costs for non-financial corporations across euro area countries. Thus, significant financial fragmentation still remains in the euro area. This is a concern for the recovery and also for monetary and macro-prudential policy.

Under the pressure of the global financial crisis and the sovereign debt crisis in the euro area, several solutions – both global and European – have indeed been adopted. Stronger crisis prevention mechanisms are now in place and a new crisis management framework has been developed. We have financial backstops. A Single Supervisory Mechanism and a Single Resolution Framework have been decided. Most of the countries in IMF/EU/ECB adjustment programmes are “graduating” successfully, and several other stressed countries are implementing structural reforms and financial consolidation. These are important steps forward, towards a more stable and equitable functioning economic and monetary union.

We have certainly turned a corner and stabilised the situation. It is an important achievement but it is not the end of the road as it is too soon to declare that the crisis is over. The euro area still faces large challenges in terms of lacklustre growth, excessive unemployment, remaining fragmentation and a low inflation period that threatens to aggravate the burden of the debt overhang still besetting governments and private economic agents. That the stressed countries were able to restore fundamental equilibria, like their external accounts, and to resume positive economic growth is of great importance. However, we face now structural medium term challenges that impair the European potential growth rate.

In my remarks today I will concentrate on issues such as the changing financial integration and financial stability nexus, on how to restore a sound and resilient financial system and finally on the need to improve our analytical tools and policy instruments.

Banks mirror their environment but also contribute to shaping it in many respects

When the crisis struck, a significant part of the banking system in several countries had to be kept alive by public capital injections and state guarantees; where strains on liquidity were present, the ECB provided a backstop in its capacity as lender of last resort. At the height of the crisis several banks found themselves with large vulnerabilities: they were undercapitalised, had fragile funding structures and, in retrospect, many had engaged in unsound lending practices. For years, banks in creditor and debtor nations had fuelled the

imbalances that so greatly contributed to the sovereign debt crisis. Several banks had thrived on complex structured investments whose risks were not well-understood, and a small number of banks had become immersed in dubious acquisitions. This is the “banking narrative” of the crisis.¹

It is true that in some countries banks were also victimised by their sovereign, especially after 2010 when the ratings and access to market suffered the contagion from what was happening with the sovereign debt crisis. With the benefit of hindsight, banks generated instability and are now recognised as having been part of the problem. With the completion of the Single Supervisory Mechanism, the phasing-in of a sound banking regulatory and supervisory framework and the strengthening of banks’ governance and ethical standards, banks can become active parts of the solution to the crisis.

Yet, these are necessary but insufficient conditions to ensure that the banking system will again become a vibrant financial engine of growth. *Why?* Because, over long periods of time, the soundness and resilience of banks also hinges on the dynamism of the economy and society: hence the habitat of banks also has to draw itself out of the crisis. The sustainability of public and private finances and the health of the broader financial system are also critical components in securing a successful and resilient banking system.

The crisis has left a heavy, uneven structural legacy across the euro area

As the earlier stages of this multi-layered financial crisis unfolded, it became apparent that several banks had grown far too large for their economies, making the fate of several governments and banks ever more intertwined. Fears of debt unsustainability in Greece sparked concerns also about the public finances and financial health of other euro area countries. Some speak of a twin crisis of “*two debt overhangs*”. Others speak of the “*sovereign-bank nexus*”: they are all referring to the same phenomenon.²

That was when the “doom loop” between weak sovereigns and weak banks took hold to full effect and when the flaws in the design of Economic and Monetary Union (EMU) became most damaging.³ While significant progress has been made towards rectifying governance failings and design flaws, the burden of the crisis on sovereigns, households and banks is considerable and unevenly distributed.

Today, growth is low in many countries that are also overwhelmed by high unemployment, especially among the youth. The general situation of lack of internal demand when some external markets start also to decelerate, explains that investment is still almost 20 per cent below what it was in 2007 which affects our potential growth. A declining demography and insufficient progress in total factor productivity, further limit Europe’s growth capabilities and make it more difficult the absorption of the existing high unemployment. Such dynamics thwart the deleveraging process of sovereigns and households, and complicate the return of bank balance sheets to financial health.⁴

In my view, the legacy of the crisis constitutes still a vulnerability for the transition process to a more effective and robust EMU. It stokes scepticism, which itself impedes the solutions to

¹ Constâncio (2013), “Fragmentation and rebalancing in the euro area”, Joint EC-ECB Conference on Financial Integration, Brussels, 25 April 2013.

² See Schoenmaker and Wagner (2011), “The impact of cross-border banking on financial stability”, *Duisenberg School of Finance – Tinbergen Institute Discussion Paper*, TI 11–054/DSF 18.

³ See Shambaugh, Reis and Rey, “The euro’s three crises”, *Brookings Papers on Economic Activity*, Spring 2012, pp. 157–231.

⁴ See Constâncio, “Growing out of the crisis: Is fixing finance enough?”, speech delivered at the Annual Hyman P. Minsky Conference on the State of the US and World Economies, Washington D.C., 10 April 2014.

the crisis.⁵ The situation had long required bold institutional reforms to the design of monetary union and we should praise the European Commission for having quickly prepared proposals for a Banking Union in 2012.

The banking union must be instrumental in resolving the crisis

In my view, the banking union must be instrumental in resolving the crisis and unravelling its legacy. It is the crucial node to secure both financial integration and stability. The reason is clear. In the euro area, about 75% of the real economy's financing needs still originate from the banking sector. What is more, banks are crucial counterparties in the broader system of financial intermediation. Therefore, the importance of establishing the Single Supervisory Mechanism and creating a level playing field for all banks across Europe cannot be overemphasized.⁶

A relevant part of this endeavour is the Comprehensive Assessment of bank's balance-sheets that will precede the beginning of the supervisory tasks by the ECB/SSM. Aiming at completing the balance-sheet repair of the banks subject to the SSM it will improve their capital and solvency position. In spite of the recent credit negative behaviour being mostly the result of lack of demand, the enhanced robustness of banks will overcome remaining credit supply restrictions that could hamper the recovery.

This process of repairing the banking system is only one part of the challenge policymakers face in Europe. The other, more fundamental part is to build a safer and more resilient financial sector that serves the real economy. This is ultimately the objective of the next phase of banking union: building a single European supervisor via the Single Supervisory Mechanism (SSM).

There are four ways in particular I expect the SSM to make a difference to banking in Europe: by improving the quality of supervision; by creating a more homogenous application of rules and standards; by improving incentives for deeper banking integration; and by strengthening the application of macro-prudential policies.

The SSM should create the conditions and incentives for deeper integration of the European banking market, which should in turn make the euro area less vulnerable to fragmentation. Barriers that existed in the past to deeper retail banking integration, for example opaque supervisory approval procedures, will no longer be relevant with a single European supervisor. The substantial compliance costs that came from having to observe different sets of rules and interact with several different authorities should also be reduced.

At the same time, the benefits of cross-border integration should increase. Cross-border banking groups will be able to optimise their internal management of capital and liquidity. Further efforts to reduce fragmentation and a drive to achieve genuine banking integration can help Europe exit the crisis in at least three ways. First, more integrated banking markets intensify competition: banks, as well as other financial market participants, will have to change their strategies. More competition means that capital is allocated more efficiently. This promotes access to new funding opportunities for companies, encourages investment and thus contributes to higher economic growth. Small and medium-sized enterprises without direct access to capital markets, in particular, may benefit the most from defragmentation.

Second, for the ECB, a re-integrated banking sector will ease the transmission of monetary policy impulses and thus enhance the effectiveness of monetary policy.

⁵ See Mongelli, "The mutating euro area crisis – Is the balance between "sceptics" and "advocates" shifting?", *Occasional Paper Series*, No 144, ECB, Frankfurt am Main, February 2013.

⁶ See Draghi, "Financial integration and banking union", speech delivered at the conference for the 20th anniversary of the establishment of the European Monetary Institute, Brussels, 12 February 2014.

Third, in several monetary unions, genuine financial market integration helps smooth out the effects of asymmetric shocks. This mechanism of risk sharing can operate through income insurance, for example, when a country's residents hold claims to dividends, interest or rental income from investments in other countries.⁷ In the US this form of risk-sharing has been shown to be more important than federal budget transfers. In the euro area, such risk sharing will need to assume an increasingly more important role, especially given the absence of a more significant central budget.⁸

On the other hand, incomplete financial integration carries significant risks. As the crisis has demonstrated, financial integration increased the risk of contagion, without in parallel generating adequate risk-sharing arrangements to offset its adverse effects. For example, increased cross-border interbank funding was not accompanied by a sufficient diversification of investment risks. As a result, banks in some jurisdictions quickly accumulated significant exposures to local assets (such as real estate), and when the crisis hit, cross-border funding was quickly withdrawn and sizeable losses had to be absorbed within national borders. Looking ahead, lack of genuine financial integration and low resilience will always expose us to systemic risks.

The crisis has also exposed our lack of some fundamental analytical tools and policy instruments

The complexity and sequencing of the crisis, as well as its morphing over time, have also exposed our weak understanding of micro- and macro-fundamentals. Here, I am talking about basic notions, not only more advanced concepts and elements.

Few economists saw the financial crisis coming, understood the serious risks generated by persistent imbalances and recognised the deep changes in economic structures and financial markets that were under way during the build-up to the global financial crisis and the sovereign debt crisis in the euro area. With EMU, the nature of prevalent shocks has changed to slow moving processes that are more difficult to tackle with the few adjustment mechanisms at the disposal of stressed countries. Facing this crisis, we were armed with a toolkit that was suited to a previous era: i.e., inadequate models and limited monitoring tools to support EMU.

It is thus understandable that the crisis has also heralded a "renaissance of research", with both positive and normative implications. One of the least acknowledged outcomes of the crisis is the enrichment of our professional toolkit to conduct economic, monetary and financial analyses. Existing databases, models, analytical tools and forecasting and projection apparatuses have been overhauled and enhanced, and new ones have been added.

Through our Department of Research we have invested in all areas of micro- and macro-research that are directly and indirectly beneficial to our economic and monetary analysis. We have launched research initiatives across European countries to understand how economies work and what drives innovation, productivity, competitiveness, growth, employment, equality and so on. Let me mention just a few examples of such initiatives undertaken by the ECB and the Eurosystem:

- ***There is the Competitiveness Research Network, known as CompNet.*** Its objective is to identify what drives the dynamics of competitiveness and productivity across EU countries and heterogeneous firms, and relate the findings to policy

⁷ See van Beers, Bijlsma and Zwart, "Cross-country insurance mechanisms in currency unions: An empirical assessment", *Bruegel Working Paper*, 2014/04.

⁸ See Hepp and von Hagen, "Interstate risk sharing in Germany: 1970–2006", *Oxford Economic Papers* 65, 2013.

outcomes. CompNet has already assembled millions of data points and observations in order to capture “non-price competitiveness”. This initiative is already showing that we need to augment our analyses with a global value chains dimension, as the internationalisation of production matters. Had we had anything similar prior to the crisis we would have been in a better position to anticipate the effects of the propagation of the crisis along the supply chain.

- ***There is the Household Finance & Consumption Network (HFCN)***. Its objective is to conduct surveys to collect household-level data on households’ income, expenditure, assets, debt and collateral. The data can then be aggregated to gauge a measure of distress of individual households and to calculate credit risk indicators, such as the probability of default, exposure at default or loss given default. Such indicators can then be subject to stress tests for which a scenario can combine an unemployment shock with an interest rate shock and a house price shock. Had such data been available prior to the crisis, it would have facilitated the identification of household borrowing and spending exuberance in several countries at an earlier stage.
- ***There is the Macro-prudential Research Network (MaRs)***. Its objective is to develop core conceptual frameworks, models and tools that provide research support in order to improve macro-prudential supervision in the European Union. The work performed under MaRs can yield more complex economic, financial and monetary indicators that can more adequately address the complexities inherent in the euro area.

In the context of MaRs and also resulting from work in our own Department of Macroprudential Policy and Financial Stability, we have developed analytical tools that include, for instance, early warning systems that can go to the level of individual banks, decision tree risk models, structural VARs and Global VARs , contagion network models and top-down stress test models for banks. One of the least acknowledged outcomes of the crisis is the wealth of tools and models now available for conducting in-depth economic, monetary and financial stability analyses. Looking at on-going developments, we are better able to interpret the current situation and assess the fiscal and monetary stances. A good example of this improved understanding is the development of the SYNFINI, the Synthetic Financial Integration Indicator, presented in our Report and that is based on measures of cross-country price dispersion in the money, bond, equity and banking markets in euro area countries.

Looking ahead, we are also better equipped to warn about looming systemic risks or adjustment failings, as well as to identify strengths.⁹

Macro-prudential policy will have an important role to play

One of the more important goals of the on-going research is the grounding and calibration of macroprudential instruments. The need for a macro-prudential perspective is one of the main lessons stemming from the crisis. In fact, the whole regulatory reform after the crisis was internationally discussed in Basle or in the FSB and the G20, from the macro-prudential perspective. Indeed improving the design of Financial Regulation to ensure a resilient system is the first instrument of macro-prudential policy.

I see macro-prudential policy as particularly important for the single currency, as macroprudential tools can in principle allow policymakers to address financial imbalances in a more country-specific and granular way.

⁹ See Fecht, Gruener and Hartmann, “Financial integration, specialization and systemic risk”, *Journal of International Economics*, Vol. 88, 2012.

I acknowledge that we do not yet have a large body of evidence on the effectiveness of these policies, especially in advanced economies. That said, the studies that do exist tentatively support the conclusion that macro-prudential policy can be effective in the euro area. Asset-side measures like LTV, LTI and DTI in particular have been found to be effective in dampening real estate booms.¹⁰ As this was the sector at the heart of the crisis in several euro area countries, this is encouraging. Further research in this area is essential to help us better understand the impact and transmission channels of macro-prudential policies.

Questions of effectiveness aside, where the SSM represents a major step forward in macro-prudential policy, is in creating some centralisation of macro-prudential decision-making. The SSM Regulation gives the ECB the power to apply stricter macro-prudential measures than national authorities if it deems necessary. This allows us to take an integrated view of macro-prudential policy – spillovers, arbitrage effects – and provides a safeguard against inaction bias at the national level.

Moreover, the important role of the ECB Governing Council in macro-prudential decision-making allows for interactions between monetary policy and macro-prudential policy to be internalised and synergies to be exploited. To give just one example, several of the non-standard measures we have adopted during the crisis, such as changes in collateral haircuts or reserve requirements, might in certain cases overlap with macro-prudential measures like liquidity ratios and margin requirements. This suggests that macro-prudential policies can support us in fulfilling our mandate.

Conclusion

Let me conclude. Since the launch of the euro, we have become more interconnected. Trade and financial links have deepened further and most companies and many banks have acquired a European perspective. We are, de facto, each other's stakeholders. During the crisis we have seen how what happens in one euro area country, however big or small, reverberates in all others.

The crisis has partly reversed some integration but, as shown in the two reports, we are now witnessing a degree of financial market de-fragmentation and reintegration.

We are also waiting for more sound research and analysis to come on stream. A deeper understanding of the issues involved is paramount to making further progress on any one of the multitude of fronts that we still need to explore. So, to this end, it is with great pleasure that I now give the floor to our panellists for what I anticipate will be an in-depth and fruitful discussion on the state of financial integration after the experience of the financial crisis.

¹⁰ For a review see Smets, F. (2013), "Financial Stability and Monetary Policy: How Closely Interlinked?", Sveriges Riksbank Economic Review 2013:3.