Mugur Isărescu: Relations between euro and non-euro countries within the Banking Union

Speech by Mr Mugur Isărescu, Governor of the National Bank of Romania, before the UniCredit 15th International Advisory Board, Rome, 10 July 2014.

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Ladies and gentlemen,

Let me first thank UniCredit and Mr. Romano Prodi for inviting me to make this address in front of such a distinguished audience. I was asked to talk about the soon-to-be-operational Banking Union, specifically about the relations between the euro area and non-euro area members and, generally, its anticipated impact on investor confidence across the European Union.

As you probably know, in my capacity as Governor of the National Bank of Romania, I have argued in favour of the Banking Union project. I see the Banking Union as a substitute for the fiscal counterpart of the Monetary Union required for the proper functioning of the latter. It is hardly imaginable that a consensus on fiscal union is achievable, particularly in today's Europe, where both payers and recipients are known beforehand. Consequently, to target first the Banking Union has the distinct advantage of actually being feasible. In this context, I am in favour of Romania's entering the Banking Union before joining the Euro area through the close cooperation arrangement with European Central Bank.

My speech will endeavour to outline the arguments that support the opt-in decision for Romania, but I believe that, despite the slightly different circumstances, the reasoning also holds true for other non-euro area countries – such as Poland, Hungary, the Czech Republic or Bulgaria.

General remarks

Before dealing with the arguments underpinning our position regarding the Banking Union, let me give you a short account of Romania's recent economic history that should enable all of you to better understand our particular circumstances.

No doubt the crisis has taken its toll on Romania's economy, given the large imbalances which had been steadily accumulating during the boom years. Whether the crisis has ended or not on the European level is still a matter of debate. What may be said for certain is that Romania undertook the necessary adjustments during the 2009–2012 period and the preconditions for sustainable growth are now in place.

Indeed, the outcome of these adjustments may already be seen in the 2013 economic performance, which hopefully marks a turnaround in Romania's economic development:

- rapid (judged by the current standards in the European Union) economic growth, namely 3.5 percent,
- sizeable adjustment of the current account deficit, from the double-digit area (between 2006 and 2008) to 1.1 percent,
- historically low inflation (1.55 percent at the end of the year),
- fiscal deficit well below 3 percent.

Improving fundamentals led to an upgrade in sovereign ratings, so that Romania is now rated again investment grade by all major rating agencies. This shift in perception is one of the reasons why Romania weathered comparatively well the portfolio rebalancing prompted by the political turmoil in Turkey and is now receiving increased capital inflows, despite its proximity to the Ukraine and the associated geopolitical tensions. Other reasons are probably related to the relatively low importance of trade with both Russia and Ukraine (less than 5 percent of total exports), as well as the comparatively high degree of self-reliance as regards natural gas consumption – Romania imported in 2013 only 15 percent of its natural gas consumption, far less than most other countries in the European Union.

From a financial standpoint, there are no direct links between the Romanian banking system and the Russian and the Ukrainian ones. There is no Russian or Ukrainian capital present in the Romanian banking system, and exposures of Romanian registered banks to entities in the two above-mentioned countries are marginal. However, there are potential indirect spill overs that could materialize through the common lender channel, given the presence of banking units owned by some Austrian and French banking groups in the two systems. The comfortable solvency and liquidity buffers in the Romanian banking system should help alleviate the effects of potential spill overs.

Euro adoption and Banking Union

For a non-euro area country the issue of participating in the Banking Union is intrinsically linked to that of ***euro adoption***. After the crisis broke out, all non-euro area EU countries in Central and Eastern Europe with floating exchange rate regimes, as well as Bulgaria, shifted to a wait-and-see approach as regards euro adoption, even though, in most of them, the Maastricht criteria were already fulfilled or within reach.

This state of affairs may appear paradoxical, given that, shortly after these countries' accession to the European Union, their euro adoption target dates were very ambitious, despite the scant progress at the time in fulfilling the Maastricht criteria – 2008 in Hungary, 2008/2009 in Poland, 2009/2010 in the Czech Republic, 2010 in Bulgaria and 2014 in Romania. None of these deadlines were met.

Currently, virtually all new Member States outside the euro zone lack a euro adoption target date, which is indicative of a ***substantial shift in approaching the euro changeover*** as a whole rather than their inability or difficulty to comply with the reference values of nominal convergence. How did this change come about?

This shift in approach ***occurred amid euro adoption benefits becoming less obvious, to which added the increasingly evident costs***. This is also reflected by the Flash Eurobarometer, which indicates a significant decline in the number of those who believe that adopting the euro is beneficial for their country. Figures differ across countries – with the lowest numbers in the Czech Republic (around 20 percent) and the highest in Romania (above 50 percent) – but the tendency is the same.

Referring to the ***benefits of euro adoption***, one of the prominent ones, namely the ***lower financing costs***, is no longer obvious.

The incomplete institutional setup of the European project in general and the European Monetary Union in particular – weak fiscal rules and the lack of any transnational instruments that would have enabled monitoring cross-border private capital flows – gave rise to a number of vulnerabilities which the recent crisis has exposed.

To be more specific, what sets the European Union apart from the other industrialized economies is precisely the fact that the initial banking crisis which hit everybody here gave birth to fears of sovereign default, which reinforced banking system vulnerability and sapped investor confidence further, thus deepening the recession.

The consequence of all that was the ***financial fragmentation issue, which is precisely the reason why the lower financing cost benefit of euro adoption, seems to have vanished***. Another unfortunate consequence was that the ***benefits brought about by commercial integration*** were significantly diminished by lack of growth in the euro area.

The fixes proposed to the institutional architecture of the European Monetary Union, such as the setup of the European Stability Mechanism and even that of the Banking Union, brought about ***direct costs of adopting the euro***. The issue here is not only the financial effort involved, but also the difficulty, from a political perspective, to explain to the public the need for a financial contribution to mechanisms benefiting wealthier countries for the time being. A case in point is the fall of the Radičová cabinet in Slovakia in 2011.

Euro adoption – a conclusion

In my view, euro adoption is in the best interest of EU Member States in the long run – given the high degree of business cycle correlation and market integration –, but several essential preconditions, added to the nominal criteria, need to be cumulatively fulfilled in order to make the most of these benefits.

I have been on this job long enough to remember a time when the dominant view was that fulfilling nominal convergence criteria was enough for successful euro area membership. The paradigm appears to have shifted. ***First***, the emphasis falls now on the sustainability of nominal criteria fulfilment. ***Second***, achievement of a relatively high degree of income per capita convergence, prior to joining the euro area, is considered increasingly important, since too much catching-up in terms of real convergence poses the risk of more intricate economic cycle management in the absence of independent monetary policy.

Third, another essential prerequisite is that the new institutional framework of the euro area has to prove its efficacy in preventing and addressing the imbalances menacing economic activity. Until then, to paraphrase the conclusion of a very recent article by Simon Tilford, having a seat at the top table, where the big decisions are made, comes at the cost of taking on much more economic risk.

To sum up, each and every Member State should put their houses in order before joining the euro area so as to be able to seize the opportunities of the single currency. I share the opinion that thorough preparedness is essential.

In Romania, a political consensus has emerged recently, as both the President and the Government stated publicly their support for 1 January 2019 as a target date for euro adoption. The objective was subsequently included in the latest Convergence programme update (April 2014), but a detailed roadmap is still pending.

Personally, I think that ***setting a target date is a good idea*** and I have publicly supported it myself. I believe that having such a target is not inconsistent with the idea of thorough preparedness, provided that the process is well-managed. Let me elaborate.

First, the opportunity to have a political consensus on a topic of national interest cannot be missed in a country such as Romania, where political passions run high and general disagreement – over almost any issue – is much more common than agreement.

Second, such an objective – feasible, yet ambitious – acts as both a policy anchor, thus fostering coherent policy action, and a catalyst for the needed structural reforms. At this point in time, Romania is fulfilling three out of the four Maastricht criteria, namely the sustainability of the fiscal position, convergence of long-term interest rates and exchange rate stability (although we are not technically in the Exchange Rate Mechanism). Meeting the price stability criterion is probably just a matter of months, until the recent low inflation numbers feed into the 12-month average rate used as a reference.

I am fully aware that we still have a long and difficult road ahead, as several years of relentless efforts are needed in order to ensure a lasting fulfilment of the Maastricht criteria, to make further progress in the catching-up process in the area of real convergence, as well as to push forward the structural reforms required for enhancing the resilience and flexibility of the domestic economy.

Banking Union

Obviously, ***euro adoption automatically implies Banking Union membership and therefore, since Romania has already set the changeover target date, joining the Banking Union is merely a matter of timing***: should it occur on the euro adoption date or as soon as possible?

There are ***strong arguments in favour*** of rapidly joining the Banking Union. ***First*** and foremost, I believe it is always preferable to have a voice in the setup of a mechanism the working of which will affect all EU countries anyway, irrespective of whether they are members or not. Participating will also have the added advantage to have first-hand knowledge of the decisions made in this context and thus avoid having partial and/or distorted information communicated by parent banks in accordance with group-level agendas.

The ***second argument*** relies on the fact that, in many of the non-euro area new Member States, the ***domestic banking systems are dominated by banks headquartered in the euro area*** – in the case of Romania, for example, euro area banks account for 80 percent of the banking system's assets; the same is true for the Czech Republic and Hungary (where foreign-controlled banks hold above 80 percent of total assets) and to a lesser – though still significant – extent in Bulgaria and Poland (around 70 and 60 percent respectively). Subsidiaries and branches of these banks are often important enough so that they are deemed systemic at the host country level, even though their balance sheets are small relative to their parent entities.

Non-euro countries are therefore already well integrated into the European financial market. Clearly, the objective of preserving the integrity and ensuring the smooth functioning of the European financial market is not something that concerns only the euro area, but is relevant at the EU level.

In this context, it is hardly surprising that Romania embraced the Banking Union idea – it makes perfect sense that the reality of a significant, even systemic, cross-border presence in the banking systems of non-euro area countries is matched by effective cross-border supervisory and regulatory institutions.

A ***third argument*** is that Banking Union membership should benefit participating countries through the ***removal of an incentive for deleveraging*** on the part of banks with foreign capital. The on-going cross-border deleveraging process, while reflecting balance sheet repair in host countries, as well as constrained demand for new borrowing, must be monitored carefully. To give you an idea of the size of the phenomenon, as compared to the beginning of the crisis, external funding from parent banks has decreased in Romania by 35 percent, about half of the reduction occurring last year. ***The rebalancing of bank funding away from parent-subsidiary lines of credit and more towards domestic funding is necessary and appropriate*** (inter alia, it reduces loan-to-deposit ratios and the stock of foreign private indebtedness, both processes impacting financial stability favourably), ***but must not be unduly accelerated*** in the short and medium term, especially when superimposed on an on-going fiscal consolidation effort, as this puts excessive downward pressure on economic growth.

As a ***fourth argument*** for Banking Union membership, there are also potential benefits which relate to ***eliminating the possibilities of jurisdictional arbitrage*** (for example, by preventing the widespread potential conversion of foreign-owned bank subsidiaries into branches), as well as to ***creating a more competitive market*** by reducing distortions and entry barriers. There is a lot of potential for increased efficiency of the banking sector by virtue of being a member of the Banking Union. A more efficient banking sector cannot but bolster the long-run growth potential of an economy. A single supervisor with a single rulebook entails that supervisory and regulatory activities should be implemented in a harmonized and consistent manner, therefore lowering or eliminating the current cost of compliance for banks with cross-border operations.

Currently, there are widespread differences in terms of the interpretation and application of regulatory and prudential definitions across Member States, and especially in what concerns supervisory forbearance. In terms of the latter, the National Bank of Romania has chosen a very transparent and tough approach, with the result that non-performing loans indicators have soared. At the moment, the non-performing loan ratio calculated based on prudential regulations stands above 22 percent. However, considering the new indicator on asset quality defined by the European Banking Authority, which covers both government and non-government exposures, the ratio declines to around 17 percent and is seen falling even further when fully provisioned non-performing loans are written off.

In this context, the recent increase in provisioning by the Romanian subsidiary of Erste Bank should not be interpreted as a tightening of the supervisor's stance in the run-up to the asset quality review, but simply as business as usual, in the sense that the bank is correctly applying the same regulations and accounting standards as the rest of the system.

Fifth and final argument, apart from the potential benefits mentioned so far, I believe that ***not opting for the Banking Union may entail significant costs*** for non-euro area countries as they are vulnerable to contagion effects. This means that, if such effects materialize, they can only rely on their own mechanisms, resources and instruments, which may prove not up to the task, a situation not unlike the one in some of the Eurozone countries during the recent crisis – the very event the Banking Union idea sprang from.

The strong presence of foreign banks in the banking systems of non-euro area countries also generates opportunity costs for not participating in the single resolution mechanism. A solution for dealing with an ailing bank, which takes into account only home country's interests, is definitely a sub-optimal outcome from the perspective of a host country. What I can say based on Romania's recent experience during the Cypriot crisis is that, even though in the end the issue of the Romanian branch of the Bank of Cyprus was solved in a satisfactory manner, having in place a single resolution mechanism would have considerably improved the situation by enhancing home-host coordination during the resolution process and by preventing the restriction of access of Bank of Cyprus' Romanian depositors to their funds.

Open issues regarding the Banking Union

An open issue regarding the single resolution mechanism refers to the treatment of ***residual losses to be covered from public funds before the required amounts have accumulated to the single resolution fund***. In my opinion, a balance must be sought between the structure of ownership of a credit institution in resolution and the origin of the public funds which may be used in the process, with home country fiscal authorities covering the majority of the proceeds, once the asset quality review has proven that host country supervision was carried out correctly and effectively.

I hope that an appropriate solution will be found to this matter, the same as in the case of the concerns voiced by some non-euro area countries in the early stages of the Banking Union project.

What I have in mind is the issue of the representation in the decision-making mechanisms and that of the contribution requirements in the event of their opting in the Banking Union. Both concerns have been addressed during the negotiations. Specifically, the unequal status of non-euro area countries in the single supervisory mechanism decision-making bodies – given their lack of representation in the Governing Council of the European Central Bank, even though they enjoy representation in the Supervisory Board – has been addressed by establishing a mediatory body which would intervene in case a decision of the Supervisory Board is overturned by the Governing Council.

Furthermore, the current decision-making setup of the Single Resolution Mechanism ensures equal treatment of the countries participating in the Banking Union, regardless of whether they are Eurozone countries or countries that have established “close cooperation”.

Finally, the concerns of non-euro area Member States that the European Central Bank’s capital key would be used as a reference for raising fund contributions have been addressed by the decision to make them proportional to bank liabilities, less own funds and guaranteed deposits, which significantly reduces the participation costs of countries with relatively lower degrees of financial intermediation, such as Romania (34.8 percent of GDP in 2013) or even Poland (53.2 percent of GDP).

Still, I think there is one particular issue where equal treatment of euro area and non-euro area members of the Banking Union is not ensured, namely ***the access to euro liquidity***. Unlike euro area countries, which have access to financing from the European Central Bank, in non-euro countries liquidity will have to be provided by their respective central banks, including in euro.

I believe there is a need to start discussions with the European Central Bank on short-term access to euro liquidity against non-euro collateral of appropriate quality for domestically-owned credit institutions. Of course, I see this access as an emergency facility, which can be tapped only under severe or imminent stress to non-Eurozone host country financial stability. The issue is relevant for Central and Eastern European countries, among which Romania, where a significant degree of currency substitution in euro persists from before 2008 in terms of the stock of both loans and deposits (in Romania, more than 50 percent in the case of loans and 30 percent in the case of deposits). Such restricted access would effectively remove any distortions between the treatment of credit institutions that are domestic legal persons, but have majority Eurozone capital ownership (where access to euro liquidity may be done via parent banks), and the treatment applicable to banks which do not have capital originating in the Eurozone.

Concluding remarks

Summing up, it is my view that Romania should be part of all three pillars of the Banking Union – despite the sequenced manner in which they will inevitably come into being, all of them are required for the Banking Union to function effectively. I trust that adhering to this European project will strengthen financial stability, further increasing confidence in the national banking sector (through the harmonisation of supervisory practices and deposit guarantee schemes), as well as fostering sustainable lending and economic growth (by reducing fragmentation of European financial markets).

My opinion that Romania should participate in the Banking Union may seem overly optimistic, but as a long-standing supporter of the European project, I believe that staying positive is the only way forward. Such an attitude was actually inspired by the many meetings I had over the years, in Frankfurt, Basel or Brussels, with some of the leading minds of Europe, among which Tomasso Padoa Schioppa, who said that “the crisis will possibly generate the means that are now lacking and get us closer to an accomplished Union”.

I do think that the severity with which the crisis hit the European Union and the scramble for solutions that followed do not indicate that the European Union is an intrinsically flawed project, but rather an incomplete one. In other words, going only halfway does not pay off.

Thank you for your attention.