Luis de Guindos: Building a resilient Economic and Monetary Union

Lectio magistralis by Mr Luis de Guindos, Vice-President of the European Central Bank, opening the XXIX Edition of the Masters Programme in European Union law of the University Carlos III of Madrid, Madrid, 5 October 2018.

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The crisis, its aftermath and the road to recovery

This autumn marks ten years since the start of the global financial crisis.

It was a seismic event that laid bare a number of weaknesses in the international financial system – and in the oversight of that system. In its wake, it also revealed profound shortcomings in the architecture of Economic and Monetary Union (EMU) which, ultimately, resulted in the global financial crisis morphing into a euro area crisis – and pushing many parts of Europe into a second recession.

Thankfully, the experiences of the past decade have prompted a strengthening of the regulations and the establishment of institutions with the necessary instruments to ensure stability. At global level this took the form of stronger regulation and cross-border cooperation. At European level, it meant a multi-dimensional reform of EMU: financial, fiscal, economic and even political.

As a result, and supported by the ECB's monetary policy, the euro area returned to growth in 2013, and has created more than nine million jobs since then.

We have come a long way. But there can be little doubt that we are still feeling the effects of the crisis and are still addressing some of the underlying fault lines. It's an important task, but it seems that it is no longer being pursued with the same sense of urgency.

That is why, today, I want to take this opportunity to highlight areas where we need to continue to push forward and put EMU on a more sustainable footing.

After briefly reviewing the progress already made, I will argue that the current debate on deepening our monetary union requires three main elements to ensure the long-term viability of the European project. First, we need to remain ambitious in completing the banking union so as to safeguard financial stability. Second, we need to revamp our fiscal rules and create a stabilisation instrument to enhance the resilience of the monetary union as a whole. Third, we need to bolster long-term economic growth by implementing structural reforms and harnessing the potential of Europe's Single Market.

Responding to, and learning from, the crisis

In order to get a clearer idea of the next steps it's worth briefly reviewing those that were taken to overcome the crisis.

The first part of the response – which was both global and European – entailed immediate crisis-fighting measures.

Facing unprecedented turbulence in the financial sector, governments in the G20 signalled their commitment to working together and coordinating their financial and fiscal policies. And they provided substantial state support to stabilise the banking sector and protect deposits.

Central banks also played a key role in responding to the instability in the system, including by adopting numerous non-standard measures. The ECB started by providing the necessary short-term liquidity in the form of fixed-rate full allotments, extending longer-term liquidity facilities, and expanding its collateral framework to maintain the transmission of monetary policy throughout the euro area. It also launched an asset purchase programme to bring the economy onto a path of inflation leading back to price stability.

Crucially, the action of the central banks was based on the understanding that, without financial stability, central banks are devoid of the necessary basis to transmit monetary impulses to the real economy.

The second crisis-fighting measure was a forceful regulatory response to enhance banks' resilience. This started with a reform of the existing international rules agreed in Basel which, in particular, led banks to increase their levels of capital and liquidity.

To limit the damage in the event of another crisis and contain the costs for sovereigns, we introduced resolution frameworks including bail-in tools. The Banking Recovery and Resolution Directive (BRRD), in force since 2016, is a crucial regulatory change in Europe that ends the culture of bailouts by the public sector, and introduces the culture of bail-ins. Banks' capacity to absorb losses has been enhanced, with minimum requirement for own funds and eligible liabilities (MREL) being set at EU level, and total loss-absorbing capacity (TLAC) for large banks being set at global level. These new rules aim to ensure that banks can fail and be resolved in an orderly fashion, and to shift the burden of crisis resolution from taxpayers to private creditors.

The crisis also shattered the mistaken belief that an exclusive focus on price stability and the soundness of individual institutions would be sufficient to safeguard financial stability.

That's why we expanded the policy toolkit to include instruments designed to address any build-up of imbalances in certain parts of the system, leading to the birth of macroprudential policy.

Concretely, this means we now have instruments which can be deployed at national, sectoral or bank level in a targeted way. For example, authorities can require banks to build up a countercyclical capital buffer in good times so that they can weather bad times. They can also impose additional requirements on banks to address risks arising in sectors such as the real estate market.

The third part of the response to the crisis was unique to Europe – setting up new institutions and frameworks. Key to this was the realisation that the long-term viability of EMU needed a comprehensive approach to address its weaknesses, not a quick fix.

On the financial union side, Europe decided to safeguard financial stability by transferring responsibility for banking supervision to the European level.[1] The European supervisory authorities were set up to make sure that the newly created single rulebook would be uniformly applied across the EU. The establishment of the banking union with a single supervisor in the euro area further ensures that banks in the euro area operate under equal conditions regardless of their location, as the ECB seeks to implement common high standards of supervision, foster a level playing field and promote financial integration.

But common supervision was always just one piece of the puzzle. Indeed, the establishment of the Single Resolution Mechanism as the second pillar of the banking union addressed the lack of mechanisms to deal with the failure of cross-border and of significant banks.

Also as regards fiscal and economic policies, the Union drew the lessons from the crisis and strengthened its frameworks. The Stability and Growth Pact was revised and reinforced by the fiscal compact. And the macroeconomic imbalance procedure was put in place to monitor and address the wide variety of economic imbalances that had fuelled the crisis.

Finally, the European Stability Mechanism was established to support countries that faced difficulties in accessing markets and to bring them back to a sustainable growth path.

All in all, the different elements of the response ensured that the crisis was overcome and that the seeds for longer-term reforms were planted.

I wish I could stop here now and say all is fine. Unfortunately, I can't. As memories of the crisis start to fade, so does the sense of urgency which drove EMU's institutional reform.

Further reforms are needed to ensure that integration in the banking and capital markets leads to better risk diversification, thus stabilising the financial sector and protecting the economy from any future economic shocks.[2] And, at the same time, we need to work on the fiscal and economic governance to make sure that economic integration doesn't bring with it an increased risk of imbalances.

Completing the banking union with confidence-building measures

Instead of finalising the banking union to reap all its benefits, we have come to what seems to be a fork in the road, with some saying we should focus primarily on risk reduction, while others are emphasising the importance of risk sharing.

Both approaches have valid arguments, and I would argue that both paths can be followed at the same time.

The advocates of risk reduction argue that the underlying vulnerabilities in the banking sector which triggered the crisis need to be forcefully tackled. In particular, there should be an assurance that the resources pooled at EU level in the banking union are not used to pay for the fallout of past policy mistakes.

And we have made progress on that front: banks are now more resilient due to their increased levels and quality of capital and liquidity buffers. MREL requirements are gradually being met, as envisaged. Progress in tackling legacy problems, such as the high levels of non-performing loans, is ongoing and should continue.

On the other hand, the advocates of risk sharing rightly argue that mechanisms are needed to build confidence in the resilience of the financial sector as a whole and that such measures are also indispensable to consolidate trust in the euro area.

Trust that, in turn, is vital to effectively reduce risks.

Cases-in-point include the establishment of a credible backstop for the Single Resolution Fund (SRF) and of a European deposit insurance scheme (EDIS).

Establishing a credible backstop for the SRF will instil confidence in the markets that resolution will happen in an orderly fashion, thus helping resolution authorities to perform their tasks while avoiding financial stability risks.

Similarly, a fully mutualised EDIS would contribute to making sure that bank failures do not trigger financial instability, as depositors will trust that their deposits are safe, regardless of the location of the bank in question. EDIS and the backstop for the SRF are thus not only risk-sharing but also confidence- building mechanisms contributing to risk reduction.

And to foster confidence that funds pooled in EDIS will not lead to systematic transfers between banking sectors, banks' contributions to the deposit insurance fund can be designed to reflect the relative riskiness of banks, following a polluter-pays principle.[3]

There are some who believe that public backstops should remain a national responsibility. But for both institutional and economic reasons this cannot be the answer.

Given the reality of the banking union, it would make little sense for national governments to individually backstop the financial sector without having the responsibility or tools for much of its supervision and resolution. Moreover, as long as national authorities are responsible for bearing the costs of crises, they will be inclined to keep resources within their borders, or ring-fence them, which in turn will undermine cross-border financial integration.

But also economically, the crisis demonstrated beyond a doubt how costly and difficult it is for national governments to manage banking crises that are ultimately international in origin and often beyond their control. Pooling of resources at European level to deal with the failure of cross-border and of significant banks is much more efficient.

Both EDIS and the backstop for the SRF would ultimately increase confidence and reduce the likelihood and the cost of a bank failure. Risk reduction and risk sharing should thus not be seen as contradictions. They complement each other and should thus move forward in parallel, reinforcing each other so as to achieve the common aim of a resilient euro area.

All in all, there cannot be a single “risk reduction” indicator which would prove that we are “safe” enough to complete the reforms of our monetary union. Similarly, there should be no false expectations that EDIS and the SRF backstop will firmly establish our Economic and Monetary Union in all its dimensions.

Revamping the fiscal rules and creating stabilising instruments to enhance EMU resilience

Private risk sharing through financial markets is essential to absorb shocks. But market-based adjustment cannot properly cope with large shocks, when the private sector as a whole contracts. In such a scenario, fiscal policies have to be activated to maintain stability, without over-burdening monetary policy. This, in turn, also ensures a stable macroeconomic environment for banks.

There can be no question that the top priority in this area is for national policymakers to build up fiscal buffers to ensure policy space for future downturns, just as bank supervisors now expect banks to build up capital buffers in good times. This is particularly important in countries where government debt is high and for which full adherence to the Stability and Growth Pact is critical for safeguarding sound fiscal positions.

But Europe has a role to play in reinforcing national fiscal policies.

In contrast to the banking union, stronger integration in the fiscal realm did not result in the establishment of effective fiscal instruments and institutions at European level to ensure stability. That’s why, as a second priority, work needs to continue on designing a more complete fiscal architecture.

Despite many reforms, the common fiscal rules that should deliver this outcome have lost traction.[4] Europe, therefore, needs to regain faith in its fiscal rules by having a frank discussion on how to make them more effective and anti-cyclical.

The rules themselves will, however, not always be enough because sound domestic policies are not always enough. Markets do at times overreact and penalise sovereigns over and above what may be needed to restore a sustainable fiscal path. This is why there is also a need for public risk sharing through a stabilisation capacity.

Designing a stabilisation instrument for the euro area is neither straightforward nor easy. But that should not be an excuse for avoiding such a discussion and for taking concrete steps towards establishing it.

Proposals have already been put on the table, for example in the form of a fiscal capacity with a direct focus on stabilisation in the shape of investment protection or an unemployment insurance mechanism. Other suggestions refer to a common budget that can provide public goods through spending on joint investment projects or the broader political aims of the European Union, such as defence.

Regardless of the exact form, it is vital that any euro area fiscal instrument comes with powerful incentives to counteract moral hazard, avoid permanent transfers and ensure sound policymaking at national level.

Bolstering long-term growth through structural reforms and allocative efficiency

The elements I have discussed so far – notably, more stable financial integration and common fiscal instruments – can provide a shield against events that trap countries in downward spirals. Long-term economic growth, however, is ultimately derived from increased allocative efficiency and innovation, which can only be achieved by modernising the euro area's economies.

Looking at the last 15 to 20 years, euro area countries with sound economic structures from the outset have shown much higher long-term real growth and are more resilient. Some euro area countries adopted ambitious reforms during the crisis and they have also seen good results afterwards – and the full effects are still materialising.

Nevertheless, over the past five years, structural reform implementation in the euro area has overall been sluggish at best. Very few reforms identified at the European level have been substantially implemented in the last few years. Reversing this trend and putting our economy on a higher convergence trajectory is thus a priority.

As structural reforms remain essentially in the hands of national governments, those governments should be the first ones to step up their efforts. Nevertheless, European policies, if further developed, can be a significant catalyst and provide a strong engine for both growth and employment, in various ways.

First, there is scope for a better use of the EU's budget. The discussions on the 2021-27 multiannual financial framework offer a vital opportunity to enhance its role in addressing Europe's structural challenges.

Second, the Single Market as an engine for convergence should be used to its fullest potential.

For consumers, the Single Market has already boosted competition in markets across the EU yielding large benefits for consumers.[5] But also on the supply side, the Single Market provides large productivity dividends by encouraging the integration of European value chains into global chains. These chains have resulted in higher wages at all skill levels.

How can these positive effects of the Single Market be further harnessed? For one, by completing it and expanding its reach into new policy areas, notably services. Services make up over 70% of total EU GDP but only 5% relate to cross-border services.[6] Expanding the market will drive economic progress, to the further benefit of consumers, businesses and the economy as a whole.

Conclusion

Let me conclude.

We have gone a long to repair the flaws in the financial, regulatory and supervisory framework which led to the crisis. We have taken bold steps to ensure that the euro is able to withstand future shocks.

Reform fatigue always sets in over time. After all, the first calls to reform the international banking rules were made directly after the crisis in 2008.[7] This year, ten years on, we are finalising the last details of these reforms, which won't all be fully implemented until 2028, 20 years on![8] Similarly, the SRF is only being gradually built up and will not reach the target level until 2024, ten years after the implementation of the SRM Regulation.

Reforms take time. But we should not stop now.

Minsky[9] taught us that good times breed complacency, exuberance and optimism among market participants. They can also lead to complacency among public authorities. While we cannot say that we are completely out of the woods, economic growth in the euro area is currently solid and broad-based. Public authorities should not let this opportunity go to waste; they should urgently complete the reforms we initiated when the global financial crisis erupted in 2008.

This includes continuing on the path of reforms to reduce risks in the financial and public sectors. But importantly it also includes risk sharing – alongside risk reduction – across national borders: through integrated financial markets, a fully fledged European deposit guarantee scheme and an incentive-compatible fiscal stabilisation function. If they are well designed, these elements can further speed up the reduction of risks in all domains.

This project is undoubtedly ambitious, but it is essential to build resilience to future shocks, foster stability and growth and improve the lives of the people of Europe.

Thank you for your attention.

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1 This choice addressed the "financial trilemma" identified by Dirk Schoenmaker, who wrote that the objectives of (i) financial stability, (ii) financial integration and (iii) national financial policies are incompatible. Any two of the three objectives can be combined, but not all three; one has to give. Dirk Schoenmaker (2011) "The financial trilemma" in Economic Letters, 111, pp. 57–9.

2 Financial integration in Europe report, Special Feature A: Financial integration and risk sharing in a monetary union, ECB, 2016.

3 See Carmassi, J., Dobkowitz, S., Evrard, J., Parisi, L., Silva A. and Wedow M., "Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?", ECB Occasional Paper Series No 208 (2018).

4 It does not help that some Member States with high debt levels are engaging in fiscal loosening during the ongoing economic expansion. In doing so, they further undermine the credibility of the rules and erode mutual trust. But even countries that were once the rules' staunchest champions are not advocating them so strongly now.

5 papers.ssrn.com/sol3/papers.cfm?abstract_id=3194929 There is evidence demonstrating that the EU has stricter competition laws, less market concentration of firms and less money spent on lobbying than in the United States. This yields direct dividends for Europe's consumers. For example, it is estimated that US consumers would gain USD 65 billion a year if US mobile service prices were in line with German ones. cefup.fep.up.pt/uploads/fin%20seminars/2017/Semin%C3%A1rio_Mara%20Faccio_25.05.2017.pdf

6 European Parliament, "Understanding the Single Market for services", Briefing, September 2016.

7 The "Principles for Sound Liquidity Risk Management and Supervision" were published in September 2008. www.bis.org/publ/bcbs144.htm

8 The final agreement on the Basel III reforms foresees a phased-in implementation of the standardised output floor over five years between 2022 and 2027. Other elements of the agreement are foreseen to apply from January 2022 (see Press release). Alongside the minimum regulatory requirements set out in the Basel III framework, large banks will be required to have at all times sufficient loss-absorbing and recapitalisation capacity available, as defined in the new standard on the adequacy of total loss-absorbing and recapitalisation capacity in resolution ('the TLAC standard'). The minimum requirements included in the TLAC standard will be

phased in from 2019 (and fully applied in 2022), but large institutions headquartered in emerging market economies will be required to meet the full requirements by 1 January 2028 (see Press release).

9 H.P. Minsky, The Financial Instability Hypothesis, Levy Economics Institute of Bard College, Working Paper No 74, May 1992.