Luis de Guindos: Deepening EMU and the implications for the international role of the euro

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the occasion of the joint conference of the European Commission and the European Central Bank on European financial integration and stability, Brussels, 16 May 2019.

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It is a great pleasure to be speaking today at the joint European Commission and ECB conference on financial integration in Europe.

The choice of the international role of the euro as the guiding theme represents a change in focus in the discussions on Economic and Monetary Union (EMU) reforms, from a post-crisis response to a broader agenda.

At the same time, Europe is facing new challenges, not least a return to fragmentation at the global level and the United Kingdom's departure from the EU, amid heightened political uncertainty.

In this context, I would like to give an overview of where we are in terms of European financial integration and draw lessons for the concrete policy actions that would promote integration.

Where do we stand on financial integration in Europe?

At the ECB, we analyse two dimensions of financial integration: price convergence across the euro area and quantity-based integration via cross-border activities.[1]

The great financial crisis caused fragmentation along both of these dimensions. Since then, we have made great progress thanks to measures to reform EMU and the announcement of our Outright Monetary Transactions. These actions, together with a wide range of policy measures taken in the years that followed, put us back on the path towards greater integration.

However, this process has stalled somewhat in the last two years.

On the capital markets side, most of the recent positive developments in terms of financial integration have been driven by an overall reduction in price dispersion, rather than an improvement in holdings of non-domestic assets, or cross-border holdings.

Going beyond the aggregate figures, however, we see that the investment fund sector makes a positive contribution to integration by allowing investors to spread and diversify their asset holdings across countries. In 2017, investment funds held roughly 78% of all their holdings in bonds issued outside their own domicile.[2] This is important because more cross-border holdings are needed to support consumption smoothing in the face of shocks and to enhance cross-border risk-sharing.

In banking markets the picture is also mixed. In general, we have seen a reduction in the cross-country dispersion of banks' funding costs and lending rates, pointing to some price-based integration.

In terms of quantity, however, integration is still fairly low as cross-border interbank lending remains stagnant and cross-border retail lending continues to be very limited.

More cross-border lending would be welcome as it could better insulate the domestic banking sectors from regional shocks, thus helping to sustain consumption or investment levels in the face of adverse shocks.

These findings have implications for the EU's policy agenda.

First, cross-border financial integration still falls short of the potential for cross-border private risk-sharing we would like to see in the euro area. While the United States is an ambitious benchmark in this respect, it is interesting to note that 40% of shocks to GDP growth can be mitigated through diversification via capital markets in the United States. This compares with only 20% of shocks to GDP growth that can be smoothed in the euro area.[3]

The capital markets union (CMU) agenda therefore needs to be pursued with renewed vigour to foster a deeper integration and development of markets.

Second, the banking union is still not a reality even though two of its three pillars have been put in place. Euro area-based banks have substantially reduced their cross-border claims since the crisis, and about 60% of banks' total exposures are to their home countries.[4]

This is worrying at a time when the political momentum behind completing the banking union is fading. Importantly, this may lead banks to refocus their activities on their domestic markets as they anticipate that the banking union will remain incomplete, resulting in further fragmentation.

Renewed risks of fragmentation increase the need for European integration

Pursuing reforms through European projects is even more important in view of a possible return to fragmentation at different levels.

At the global level, a lack of commitment to fully implement internationally agreed standards may hinder international activity. Europe should be taking a leading role here and promoting an integrated and level playing field within its own borders and beyond by implementing the agreed reforms and maintaining a high-quality regulatory framework. This will provide confidence in the health and resilience of our markets and buttress Europe's credibility as a rule-maker.

From a global perspective, European capital markets are currently too small and too fragmented. The CMU agenda should therefore be geared towards creating the ecosystem needed to develop more vibrant European financial markets and intermediaries that are able to compete internationally. This means both promoting policies that help markets to increase their size and scope, and doing away with the barriers to the cross-border functioning of markets implied by differences in national policy concerning insolvency, taxation and other areas. Promoting a single rulebook in a wide range of areas, including consumer protection, anti-money laundering and accounting rules, is also key to the success of CMU. Regulatory consistency in a broad sense and a level playing field, as opposed to leniency, are crucial to render EU markets attractive.

At the European level, Brexit is an additional challenge which may lead to fragmentation as services could be provided in a more decentralised way. At the same time, EU27 capital markets are still subject to national rules and supervision, making for a patchwork of regimes which prevent the integration of markets and may open the door to regulatory arbitrage. As a response to Brexit, we need to develop truly European capital markets, and this makes progress on the CMU front even more urgent.

As the United Kingdom leaves the EU's regulatory and supervisory framework and develops a new one of its own, a different relationship between the two jurisdictions will need to be defined. It will need to balance the benefits of continued integration with the UK financial markets with the potential risks to financial stability, consumer and investor protection, and the integrity of the Single Market. This path will not be easy for either side as the lure of the flexible and light-touch regulation of the past can be strong, bringing with it the risk of divergence between EU and UK rules or a potential race to the bottom. And these considerations will also play out as we review the role of equivalence regimes in EU financial legislation.

European responses are the way forward

Turning to policy responses, the way forward is clear: we need to move away from national responses and promote European ones within the CMU and banking union agendas. Let me briefly emphasise five priority areas.

First, we need to complete the banking union's institutional architecture. In particular, we should ensure that the backstop to the Single Resolution Fund is fully operational, agree on a banking union solution to liquidity needs in resolution and define a clear path towards a European deposit insurance scheme (EDIS). A fully fledged EDIS would facilitate cross-border banking since depositor protection would be independent of a bank's location, and ensure that an increase in cross-border activity does not reduce the overall resilience of the system. This would provide the institutional framework for the cross-border risk-sharing that Europe needs.

Second, to facilitate cross-border activity and the emergence of pan-European entities, we need to put an end to national ring-fencing. Within the banking union, supervisors should be able to grant cross-border waivers for capital, liquidity and large exposures, provided that prudential safeguards are in place. This would lead to more efficient resource allocation and support the emergence of resilient cross-border banks able to provide credit across borders and to offer investors access to diversified products.[5] It would also foster cross-border bank penetration, which would support the credit channel of private risk-sharing. Within CMU, a more level playing field would also enhance the capital market channel of risk-sharing.

Third, we need to mobilise the large existing pool of savings in Europe so it can be put to productive uses. Today, households keep 35% of their financial wealth in cash and deposits, around a third in insurance and pension funds, and the rest in shares, funds and bonds. Differences in saving behaviours – through banks or through pension funds – suggest that there is potential for savings to be allocated more efficiently within the banking union and for retail investors to participate more actively in capital markets. Fostering equity investment by addressing the debt-equity bias and improving financial literacy, for instance, would support the development of an equity culture in Europe, which would, in turn, help to finance innovation, growth[6] and risk-sharing[7], while also increasing the return on savings for households.

Fourth, we need to continuously review the financial regulatory and supervisory framework to ensure that authorities can monitor and address potential financial stability risks. European firms are relying more heavily on corporate bonds for their financing than they did in the past, and both households and various financial intermediaries are increasingly holding corporate bonds via investment funds. This changing environment might entail new sources of risk as well as different transmission channels of financial instability. Robust prudential standards in the non-bank financial sector therefore need to be upheld, and changes to the financial structure need to be reflected in the supervisory framework to avoid risks developing beyond the watch of supervisors. The macroprudential toolkit will also need to be extended to the non-bank financial sector so that the authorities have the means to address risks at the system level.[8]

Last but not least, we should not shy away from having an open discussion on the need for a European safe asset. If well designed, such a European asset could become the benchmark for investors in EU capital markets, reduce the incentives for capital flight on national bonds within the euro area and contribute to lowering risks on banks' balance sheets.

Deeper financial integration will strengthen EMU and ultimately enhance the international role of the euro

More developed and integrated banking and capital markets play a complementary role in financing the real economy by providing different sources of financing adapted to various funding needs and stages of firm development. They also help to match borrowers and investors in an

efficient way.

Efficient capital and banking markets also contribute to fostering cross-border private risk-sharing via the credit and capital channels, which reduces the need for public risk-sharing and enhances the resilience of EMU.

We therefore need to promote a European approach to financial integration so that we can complete both the banking union and the capital markets union. Achieving developed, integrated EU markets that are open and attractive to international investors would ultimately reinforce the role of the euro on the international stage.[9]

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1 The ECB regularly releases a set of financial integration indicators and since 2007 has published a report on "Financial integration in Europe". Integration is measured using both price and quantity-based composite indicators. They aggregate market-specific indicators related to money, bond, equity and banking markets, thereby offering a comprehensive overview of financial integration in the euro area.

2 ECB (2018), *Financial integration in Europe*, Special Feature B "Integrating euro area corporate bond markets: benefits and potential financial stability challenges".

3 See ECB (2018), "Risk sharing in the euro area", *Economic Bulletin*, Issue 3, and Alcidi, C., D'Imperio, P. and Thirion, G. (2017), "Risk-sharing and consumption smoothing patterns in the US and the euro area: A comprehensive comparison", Centre for European Policy Studies Working Document, No 2017/04, May.

4 ECB (2017), Financial Stability Review, Special Feature B: "Cross-border banking in the euro area since the crisis: what is driving the great retrenchment?", November, and EBA transparency exercises and EBA stress test exercises, 2013–2018.

5 ECB (2017), *Financial integration in Europe*, Special Feature "Cross-border bank consolidation in the euro area".

6 See, for instance, ECB (2007), "The role of financial markets and innovation in productivity and growth in Europe", *Occasional Paper Series*, No 72, as well as ECB (2018), *Financial integration in Europe*, Special Feature A: "Financial development, financial structure and growth: evidence from Europe".

7 ECB (2016), *Financial integration in Europe*, Special Feature A: "Financial integration and risk sharing in a monetary union".

8 See, for instance, "Redesigning Europe's financial landscape ", speech by Luis de Guindos, Vice-President of the ECB, at the 6th Frankfurt Conference on Financial Market Policy, Frankfurt, 14 December 2018.

9 In the literature it is argued that in modern times the size, depth and variety of domestic capital markets are key factors in fostering the international role of a currency. See McCauley, R. (2017), "The Euro and the Dollar", *Essays in International Finance*, No 205, Princeton University, November; Hartmann, P. (1998), *Currency Competition and Foreign Exchange Markets: The Dollar, the Yen and the Euro*, Cambridge University Press; Portes, R. and Rey, H. (1998), "The emergence of the euro as an international currency", *Economic Policy*, Vol. 13(26), pp. 306–343; Hartmann, P. and Detken, C. (2000), "The Euro and International Capital Markets", *International Finance*, 3(1), pp. 53–94.