

20.05.2019

The Need for Deepening Euro Area Integration

City Week 2019: The International Financial Services Forum

Pablo Hernández de Cos

Governor

Ladies and gentlemen,

Let me start by thanking Maurice Button and the Board of Patrons of City Week 2019 for their invitation to participate in City Week 2019. It is a pleasure to be here together with leading participants from the financial sector.

2019 marks the year in which we are celebrating the 20th anniversary of the launch of the euro. However, this celebration is taking place at quite a challenging point in time. The legacies of the crisis in terms of unemployment and debt, the rise of populism, the threat posed by protectionism and uncertainties stemming from Brexit all make for a complex situation.

But to the surprise of many, this background has not reduced European citizens' support for the European integration process. Quite the opposite I would say. **Euro area citizens have declared the highest level of support for the euro ever recorded.** The latest Eurobarometer survey shows that 74% of citizens across the euro area countries favour the Economic and Monetary Union (EMU), with a single currency, the euro. The survey also reveals strong support for more coordination and economic reforms to improve the performance of national economies.

These figures provide solid grounds for European governments and institutions to combine efforts aimed at making the euro area architecture more robust and resilient to shocks, and at increasing its ability to respond when shocks occur.

Admittedly, **Europe has already taken bold steps to increase its capacity to detect and handle crises.** During the crisis years, two new intergovernmental treaties were introduced, paving the way for strengthening economic and fiscal stability by **creating the European Stability Mechanism.** This key instrument provides financial assistance to countries in difficulties and, as recently agreed, may also act as a fiscal backstop in banking resolution processes. New procedures for the surveillance of imbalances (the **Macroeconomic Imbalances Procedure**) and the **reform of the Stability and Growth Pact** were also agreed.

In the financial arena, important reforms, such as the creation of the **Single Supervisory Mechanism** and the **Single Resolution Mechanism** for significant banks, were implemented. On top of this, the impulse of monetary policy, with a substantial **broadening of the ECB's monetary policy toolkit**, was also a crucial factor that helped cope with the Euro crisis and its negative impact on price stability.

Attempts to draw comparisons between the governance framework in the United States and the European Union should be mindful that the US currency union has had 150 years to evolve, while the European currency union is still rather young. Nonetheless, it is precisely **with this long-term perspective that we have to judge EMU.**

All in all, while acknowledging the relevance of the various institutional changes made, a broad **consensus points to the fact that additional reforms are needed in the EU's architecture**, and in particular in the architecture of the European Monetary Union.

Against this background, allow me to briefly sketch those reforms which, in my view, deserve more attention in EU policy-makers' agendas during the next institutional period following the European elections.

First, there is an urgent need for more progress to **complete the single market for services**. For example, by addressing obstacles in the regulation of professional services and other administrative barriers, and by enhancing cross-border cooperation in the energy sector.

Second, there is also a pressing need to **strengthen and simplify the fiscal framework**. The current fiscal rules have proven to be overly complex, hard to enforce, and unable to prevent a procyclical fiscal policy. Moreover, steps in this direction might be essential for promoting economic stability and a more favorable environment for investments ahead of the challenge of digitalisation.

Third, more efforts need to be made to **preserve the multilateral system of trade**.

Focusing now more on **specific euro area reforms**, I would highlight in particular two priorities which, in my view, should be at the center of the discussion.

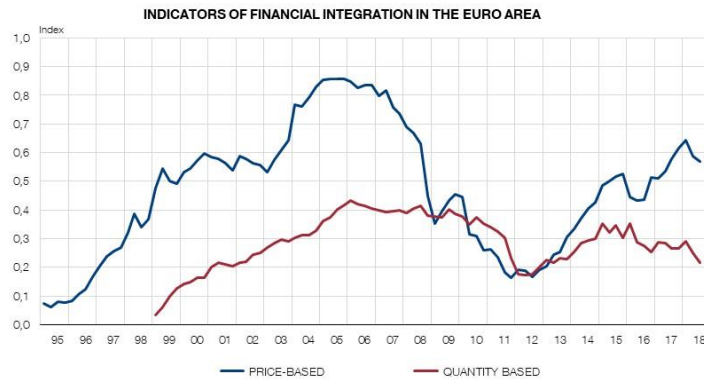
Firstly, the need to **increase financial integration** and the development of European capital markets by **reinforcing the Banking Union and the Capital Markets Union initiatives**. Secondly, progress towards a **more comprehensive fiscal stabilisation capacity** at the Eurozone level.

The need to increase financial integration

European citizens and firms still face several barriers to investing across European markets. Pensioners and investors in different countries have access to different investment products and their rights differ as a result of diverging local insolvency laws.

The banking sector still remains mainly national, and intertwined with the sovereign of its host jurisdiction. For bank depositors and national authorities, the current situation is such that the ultimate backstop for insuring deposits in a failed institution relies completely on a national government which has a limited say on the on-going supervision and resolution of the failed institution. This is so since decision-making processes on these responsibilities are now adopted by the European single mechanisms.

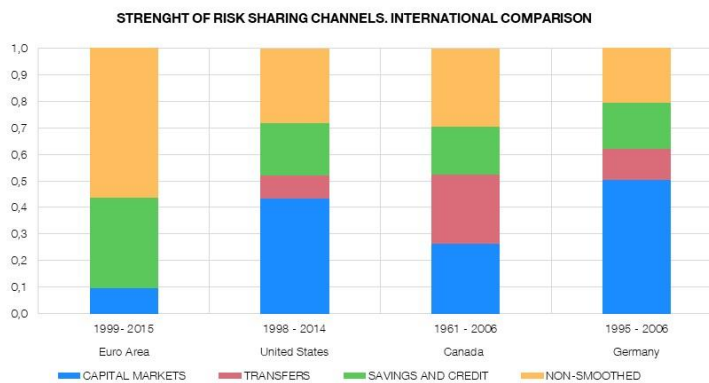
FINANCIAL INTEGRATION IN THE EURO AREA REMAINS LIMITED



Notwithstanding cultural, legal or historical reasons, these inconsistencies and obstacles are broad-based, and stem from pure regulatory barriers, a lack of infrastructure or limited political resolve. The results are pervasive. **Investment portfolios are not well diversified and investment opportunities are lost** as these may not always be matched with savers' funds. **The financial system remains fragile and fragmented** because of the doom-loop between sovereigns and banks.

An important consequence of insufficient integration is the **limited capacity of risk-sharing mechanisms in the Euro Area countries, compared with those of the United States.**

PRIVATE RISK SHARING CHANNELS IN THE UEM REMAIN VERY MODERATE AND THE PUBLIC CHANNEL IS NON-EXISTENT



As you know, risk-sharing is the ability of countries to diversify country-specific shocks among other member states through the cross-country savings and capital market channels (i.e. the private risk-sharing mechanisms), as well as through fiscal transfers (the public sector channel).

With regard to the private channels, the degree of **risk-sharing through capital markets is comparatively low** in Europe. And although it moved on a rising trend during the pre-crisis years as a result of the increase in wholesale financial integration, it subsequently fell, remaining at levels well below those observed in the United States. Limited development of equity markets in Europe, prevailing national investment bias in the Euro area relative to that in the United States, and a greater concentration of cross-border investment in a small number of Member States in Europe are some of the reasons explaining such divergent reactions between these two financial areas.

The budgetary channel is practically non-existent in the euro area. By contrast, in the United States, estimates show that the public channel helps soften between 10% and 20% of adverse shocks in a particular State.

As a result, **the credit channel is ultimately the sole means for cushioning shocks across Euro Area countries.** However, the credit channel is not enough to compensate for the weakness of the other channels. **This means that, on average, between 40% and 60% of an adverse shock impacting a Euro Area country translates directly into a decline in that country's consumption.** These figures are double the impact calculated for the United States.

Besides the need to strength risk-sharing mechanisms to address macroeconomic shocks, achieving key targets such as **controlling the levels of public debt and reducing the sovereign risk nexus** (often cited as the most fundamental original flaws of the euro design) do not only depend on introducing policies of pure fiscal discipline. They also **require soundly functioning and well-integrated financial markets capable of diversifying risks across borders and correctly pricing concentration risks.** This is why, in my view, the most immediate and significant challenge facing EMU is to reinforce the integration of both banking systems and capital markets.

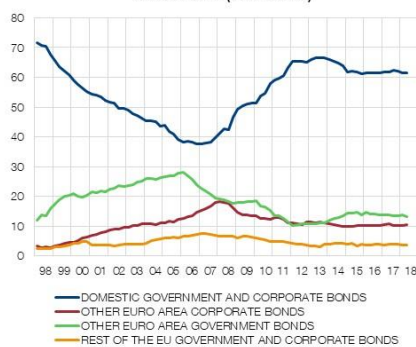
Reinforcing the Banking Union

When the euro was launched, there was actually an expectation that many banks would become truly European, providing retail services across the whole euro area. **The reality is quite different.**

IN THE EURO AREA GOVERNMENTS, FIRMS AND HOUSEHOLDS ARE HIGHLY DEPENDENT ON DOMESTIC BANKS

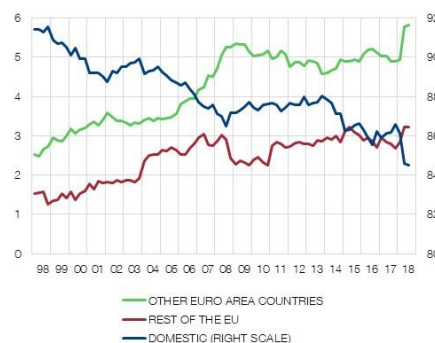


EURO AREA. HOLDINGS OF SECURITIES BY MONETARY FINANCIAL INSTITUTIONS (% OF TOTAL)



SOURCE: ECB

EURO AREA. LOANS FROM MFIs TO NON-MFIs (% OF TOTAL)



Cross-border consolidation remains very limited and most firms and households in the euro area remain largely dependent on their domestic banking systems to maintain investment and smooth consumption profiles.

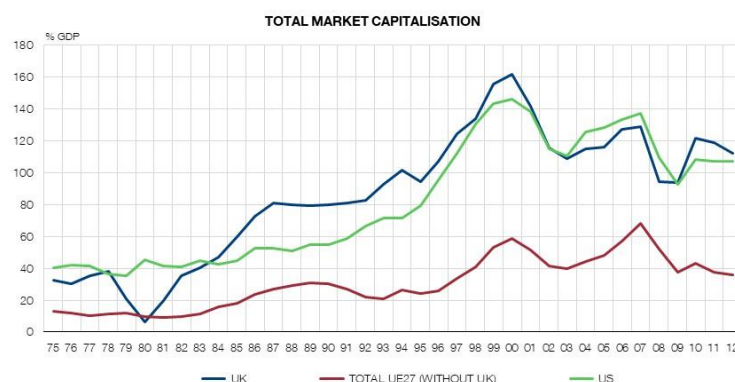
Although no formal barriers to foreign banks exist, relevant distortions arise from still **significant specificities in banking regulations across countries**. Some of the existing savings banks, government-owned banks or regional banks in the EU are **protected by national legislations hampering incentives to compete** or effectively sheltering them from competition. Moreover, **regulation fails to fully acknowledge the benefits generally arising from geographical diversification in a single market**.

We also need to **address the current deadlock on the third pillar of the Banking Union, the European Deposit Insurance Scheme (EDIS)**. Some experts argue that this third element may not be essential once we have in place a stringent resolution framework with homogeneous bail-in requirements; but in my view, it remains crucial to make EDIS a reality. Such a scheme would have a strong impact on trust and contribute to increased risk-sharing, insofar as it is designed as a fully fledged mutualised EDIS. **Contributions to EDIS taking into account bank-specific risks could limit the risk of permanent cross-subsidisation and would also help deal with the sovereign-bank nexus**. This would contribute to reducing the link between national governments and banks and preventing destabilising cross-border flights to safety in the event of difficulties.

Moving towards a Capital Markets Union

The other key initiative to increase the integration of Europe's financial markets and to facilitate risk-sharing capacity in EMU is **the Capital Markets Union project**. The project aims at providing firms with the same funding opportunities, and households with the same saving opportunities, irrespective of the member state in which they are located.

CAPITAL MARKETS DEVELOPMENT IN THE EU IS LIMITED



SOURCE: Federal Reserve Bank of St. Louis

However, **inconsistent regulations, as well as varying market practices and industry standards across EU countries, prove to be key impediments in developing a truly pan-European capital market.**

As a result, **country savings and investments are still highly correlated**, a fact known as *the Feldstein-Horioka puzzle*. This correlation has subsided over time in the case of the European Union but is still sizable, **which is more bewildering in the case of the currency union**. A departure from perfect capital mobility has important economic implications, as it might be leading to lower aggregate investment, a higher home bias in investment decisions and a lack of portfolio diversification.

The **Capital Markets Union project has received a stronger push over the last few months**. Most of the work in terms of harmonising investment products across the EU has already been agreed. Progress on savings products has also been achieved. In particular, the development of the market for the **Pan-European Pension Product** is particularly relevant considering the situation of public finances in many EU countries and the challenges posed by population ageing. But, looking ahead, greater headway is needed over the coming years. In particular, allow me to highlight three dimensions.

First, the legal framework: **Insolvency regimes** vary widely across jurisdictions for financial and non-financial corporations, as a result of cultural traditions and legal frameworks. This is a major obstacle for cross-country investments and, I would add, a very difficult one indeed to overcome.

Second, the **strengthening of European regulators**. As European markets become more integrated and technologically complex, this is becoming a more essential element that policy-makers need to address. It will be even more important since, depending on the final outcome of negotiations, Brexit might increase the risk of fragmentation, as some companies and transactions may be reallocated to various possible destinations, while others may remain in the UK.

Third, more needs to be done in **terms of making capital taxation more consistent**. The debate has stalled in this regard. For example, the various regimes for withholding taxes, with more than 90 types of forms in different languages, are often cited as a huge obstacle for investment by market participants. Moreover, the favorable tax treatment of debt compared to that of equity has significant economic implications.

A well-functioning Capital Markets Union will have major ramifications as it will **attract institutional investors, improving the allocation of resources and strengthening the international role of the euro**. Crucially, it will help reshape capital markets in Europe after Brexit. I believe that this project is essential for the Single Market, for the Economic and Monetary Union and a resilient euro, and, ultimately, for the EU's global competitiveness. I am certain that these and other matters will be raised and discussed during the following panel of this conference.

The case for a fiscal stabilisation capacity

But, **even if developments in European financial markets were complete, private risk-sharing would still be inefficiently low**. This is because private investors do not yet internalise the positive macroeconomic stabilisation externalities of their portfolio choices. In this context, **the other area that urgently needs addressing is enhancing the stabilisation capacity of the euro area through fiscal instruments**.

Moreover, **the efficiency case for fiscal risk-sharing ultimately hinges on the relevance of idiosyncratic shocks and the capacity of national fiscal policy to face these shocks**. The efficiency argument meets the responsibility argument in the case of fiscal liabilities stemming from inadequate Euro-wide policies, as is now the case of financial supervision and resolution.

True, some evidence suggests that national business cycles have now become more synchronised. But it is clear from economic developments over the last decade that the mere sum of **national fiscal buffers may not be enough to accommodate severe common shocks**.

In addition, although in normal circumstances monetary policy should be able to deal with aggregate shocks, it may not be the case in situations in which monetary policy is already operating at the effective lower bound.

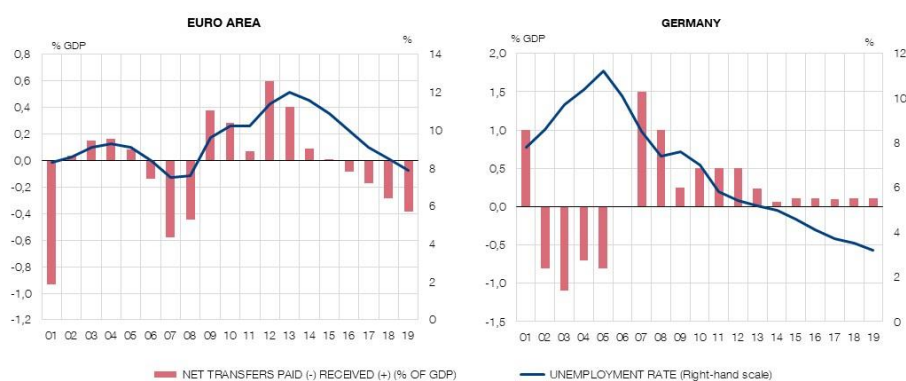
As the comparative analysis reveals, all other mature currency unions have centralized fiscal tools allowing governments to take actions when difficulties arise in a particular state or in situations of an aggregate recession. Despite several measures taken in response to the crisis, the **EU still lacks fiscal tools to cushion against asymmetric or large systemic shocks that may arise in the Euro area**.

At the latest European Summits, a consensus seems to be emerging for a small budget within the EU's regular budget, earmarked for specific support for member states in the form of loans **seeking to promote competitiveness and convergence, in particular in the areas of innovation and human capital**. While such a budget may be a first step towards more ambitious instruments, we should realise that its limited size would not make

it a suitable tool for smoothing the adjustment costs for countries experiencing a severe shock. And nor would it contribute to improving the design of fiscal policy at the euro area level in the event of a widespread recession.

By contrast, **a centralised fiscal capacity could contribute to both aims through temporary fiscal transfers** for countries experiencing a particularly adverse shock. Several proposals have been discussed. They include the need to designate a Euro area finance minister with her own budget for macroeconomic stabilisation, a rainy-day fund with or without the possibility of issuing debt, a European unemployment (re-)insurance scheme, and so on. Views on these proposals, however, differ in terms of size, allocation of competences, political feasibility and in many other respects.

**A CENTRAL FISCAL CAPACITY FOR THE EURO AREA
COULD CONTRIBUTE TO SMOOTH AGGREGATE AND
COUNTRY-SPECIFIC SHOCKS**



SOURCE: Banco de España

According to Banco de España simulations, **the effective design of any of the proposals needs to be sizable enough to provide stabilization for an economy facing a recession**, even a large economy facing a deep recession. The trigger mechanism must be clear and smooth to ensure a timely response. But it should also address legitimate concerns over moral hazard and permanent transfers. The phasing-out should ensure **that fiscal transfers will not be permanent so as to avoid undue redistribution across member states**.

To preserve sound incentives, in my view, countries with access to this instrument must comply with fiscal rules and with the rules of the Macroeconomic imbalances procedure. Even countries with a good fiscal record can fail to deal with sizable shocks, but *ex ante* compliance with fiscal rules –and a transparent process– is necessary to dispel doubts about the behaviour of the country under stress, while also providing flexibility for national fiscal buffers.

The Banco de España simulations show that, with an annual contribution of 0.35% of GDP per country, it is possible to design a fiscal capacity with a risk-sharing capacity similar to that of the existing instruments in the US. **If such an instrument had been in place since**

the inception of the Euro, most countries (and not only the usual suspects) **would have benefited from the scheme at one point, without permanent redistribution** across countries.

Finally, the creation of a common safe asset for the euro area should be explored further. The normal operations of markets and financial intermediaries require a broad spectrum of assets with sufficient liquidity and minimum counterparty risk. This situation is amplified in turbulent times, as investors react to increases in uncertainty by accumulating assets with a low level of perceived risk. Within the EMU, the volume of such assets is insufficient, as only the debt of a small group of countries is perceived as riskless, thereby giving rise to scarcity and financial fragmentation. An improvement in the fiscal position of countries might help expand the number of available safe assets. But a common safe asset will have additional benefits, by contributing to reducing the link between national governments and banks; preventing destabilising cross-border flights to safety in the event of difficulties; and, more generally, promoting a more stable and equitable provision of safe assets for the EMU as a whole.

In sum, there is a pressing need to improve the functioning of the EMU before the next crisis hits. Increasing financial integration and introducing fiscal instruments to improve macroeconomic stabilisation are of the utmost importance in achieving this goal.

Thank you for your attention.