

## **“Built to Last”: The New Euro Area Framework**

**Speech by Yves Mersch, Member of the Executive Board of the ECB,  
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Ladies and Gentlemen,

The building we are in was bought by the Drapers' Company from King Henry VIII in 1543. It has lived through turbulent times, from fires to conflicts - and, I should also say, various financial crises. But Drapers' Hall has always recovered from the calamities it has faced. It has been rebuilt, renovated, enlarged and embellished. Thus, it was built to last – but has changed over the centuries. Today, I'd like to speak about a quite different building: the “new euro area framework”.

The euro area has been facing insufficiencies on several fronts, all at the same time. Let me be blunt: it has had governance shortcomings, stretched states, fragile banks, shrinking economies, sinking confidence in institutions and doubts about its integrity. Each of these difficulties has exacerbated the others; it has been a vicious circle. The crisis did not originate in the euro area, nor is it limited to it. But inside the euro area it has inflicted severe losses and pain, particularly on the younger generation.

Yet, in the euro area an unsuspected amount of repair is under way. The threat of a break-up has vanished since last summer. A new political economy is within reach. The foundations of a virtuous circle are already here. My message today is that the euro area is being rebuilt to last. Its foundations are being strengthened and new pillars and floors are being added. The euro area will remain both viable and beneficial to its citizens.

In the light of these testing circumstances, I would like to give some tentative answers – to four questions: *Where do we stand? What are the strengths of the euro area? What's next? What remains to be done?* I will then offer some final remarks, and answer your questions.

### **Where do we stand?**

The European Central Bank has been in “crisis mode” for almost six years. The challenges for us have escalated in various stages. Allow me to recall them very briefly.

- The first stage was the *financial turmoil* that erupted in August 2007 when the US sub-prime mortgage crisis started to unravel.<sup>[1]</sup> Globally, counterparty risks rose and confidence among market participants plummeted. This led to a drying-up of liquidity, and a sharp increase in risk premia.
- The second stage of the crisis started in September 2008 after Lehman collapsed. Money markets froze, financial losses soared, bank deleveraging accelerated, and financial stress spilled over to the real economy. Trade and growth were hit hard. The ensuing global financial crisis gave rise to the *great recession*, which affected European countries disproportionately due to their high degree of openness.
- The even more serious third stage came in May 2010 when the euro area sovereign debt crisis erupted in Greece and spread to other countries.

*What happened?* After the launch of the euro, various cracks in the currency edifice emerged. Public finances were weak in several euro area countries; macro imbalances were persistent in others. Some countries experienced a boom in

housing and construction and productivity growth was slow in others. The triggering event of the turmoil, on the other side of the Atlantic combined with the disappearance of “abundant money” exposed and deepened those fault lines. Several European economies became steadily weaker.

The underlying reasons were several: there were shortcomings in governance (both national and supranational), flaws in the design of the euro area, misjudgements by regulators and supervisors, and also insufficient scrutiny by financial market participants as well as by credit rating agencies. They did not sufficiently differentiate between borrowers. And I should not omit from this list the many economists who failed to see the systemic risks building up. The ensuing dysfunctional policy debate and the discordant national responses were also harmful. Understandably, national disaffection rose, as did scepticism about the euro area<sup>[2]</sup> - this is a phenomenon I know you are rather familiar with.

Various doom-loops followed. The fates of governments and banks became ever more intertwined. Sovereigns had to recapitalise impaired domestic banks and support feeble domestic economies. In doing so, they accumulated extra debt. Perversely, even sound banks have been affected by the weakness of their home governments and domestic economies. Then, lower credit ratings and higher interest spreads of both banks and sovereigns pulled each other further down. This hurt the real economy and started a vicious circle that has been very difficult to stop and reverse.<sup>[3]</sup>

Banks across the euro area are now deleveraging and recapitalising, and the flow of credit is still hampered in several countries, mainly those in which households and firms are also trying to deleverage, while budget consolidation is under way. The functioning of the money market is severely impaired, credit is squeezed and the transmission mechanism of monetary policy is clogged.

The sovereign debt crisis came to a climax in mid-2012 when the risk of break-up seemed acute. Investors began shifting deposits away from banks in stressed jurisdictions, often to banks in countries where conditions were calmer. The deposit base fell in stressed countries. Correspondingly loan growth deviated greatly across the euro area. Small and medium-sized enterprises were, and still are, affected the most.

*What has the ECB done?* Over the last six years it has eased the credit squeeze, fought back against the economic slowdown, and countered financial fragmentation by slashing interest rates, flooding the banking sector with liquidity and lending widely. It took large scale conventional monetary policy measures to prevent deflation. Its unconventional measures prevented a meltdown of the financial system and aimed to restore the impaired transmission of monetary policy. Yet, credit flows remain weak and growth is still anaemic.

**To sum up where we stand:** the sovereign debt crises of the euro area is a multi-layered affair: economic and financial imbalances plus failings of governance and flaws in institutional design, plus an erosion of trust and confidence. It's an exceptionally complex situation. Five euro area countries are now undertaking EU/IMF adjustment programmes, while a few others are addressing imbalances outside a programme.

### **What are the strengths?**

Despite the depth of the crisis, the exceptional “flow and stock adjustments” under way, and ongoing financial market tensions, there are still some strong components supporting the building of the new euro area framework and holding things together.

The **first strength** is the resilience of the single market, which has steadily transformed the now deeply interconnected euro area economies. Companies and banks have a European perspective and reach. We are each other's stakeholders. Economic integration is a diffuse process. It is the true engine of European integration and is generating largely benign effects. The single market represents the intrinsic value of the euro area. It is a common good. It is an asset shared by all its citizens – a fact which is not given enough recognition as a stabiliser during these difficult times.

The **second strength** lies in the solidity of our financial infrastructures: they have withstood the full force of the crisis. The Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET2), has enabled money market access throughout the crisis and for all countries: the cumulated imbalances are now steadily receding. In 1998 there were 18 large-value payment systems: that number fell to six in 1999 and now there are two, which means that both efficiency and financial stability have been enhanced. Central clearing counterparties (CCPs) for securities and derivatives declined from 13 in 1999 to nine in 2012. This entails greater efficiency gains by pooling activities. And more is coming. In 2008, the Single Euro Payments Area started to take effect due to time-lags. And the securities settlement systems will change radically once TARGET2-Securities becomes operational. This project is fully on track.

The **third strength** lies in the widespread acceptance of the need for adjustments and reforms in all dimensions of the crisis. The political authorities have taken action. They are already overhauling the political economy of the euro area, and establishing new governance to restore fiscal sustainability and prevent and correct macroeconomic imbalances. The Stability and Growth Pact has been tightened up by the so-called “six-pack” of economic governance measures, including the Macroeconomic Imbalance Procedure (MIP), and they in turn have been complemented by the “two-pack”. Moreover, euro area countries are summoning up the courage to change – although it is painful in some regions. To quote Jean Monnet, one of the founding fathers of the European Union: “People will only accept changes under the pressure of necessity.” Indeed, change is under way in Europe. And the impressive political determination to reform together is not stopping at the national level.

Also a **fourth strength** is that as a result of the crisis, a “crisis management and resolution framework” has emerged at the European level– and it is working. The initial stage was a fiscal backstop, the European Financial Stability Facility, and then the European Stability Mechanism. Confidence is slowly returning to both financial markets and high streets, even if growth and job prospects remain weak – the latter two being lagging indicators of the recovery under way. All this shows that European countries can turn themselves around.

**To sum up the strengths:** the “repair work” on the euro area foundations is under way. Imbalances are slowly receding. Also there is the wide international circulation and relative strength of the euro as well as a stable demand for the euro as a reserve currency.

Yet, we are aware that deep reforms throughout the new framework are only as effective as they are completed, transposed, well explained, understood, adhered to, and given the time to display their effects. We know that we are not completely out of the woods.

### **So what's next?**

With the establishment of the ECB in June 1998 and the launch of the euro on 1 January 1999 monetary policy was centralised. Responsibility for the euro was entrusted to a strong and independent central bank. The ECB has fulfilled its primary objective of price stability. Fiscal policy, economic policies and supervision, however, have remained at national

level. As this architecture has proved to be flawed, the respective Presidents of the European Council (Herman Van Rompuy), the European Commission (José Manuel Barroso), the Eurogroup (then Jean-Claude Juncker) and the ECB (Mario Draghi) drew up what is known as the “Four Presidents’ Report”. It advocates the completion of monetary union by way of an additional “four unions”.

These “four unions” are envisaged to mesh with each other, like cogwheels. The spin of one sets the others in motion. Conversely, when the momentum of one decreases the others follow suit. The banking union, the fiscal union, the economic union, and the political union<sup>[4]</sup> can transmit and reinforce the dynamics of European integration.

Let me elaborate on some key features of the banking union – a project with which I am closely associated. The fragmentation of the banking system along national lines has posed a direct threat to the integrity of the single currency. We need to break the doom-loop between sovereigns and banks, restore the confidence of depositors and investors – in fact rebuild trust in the whole financial system – as well as ease the reintegration of financial markets. The banking union will help to restore the proper transmission of monetary policy and relieve the ECB of some of the tasks undertaken during the crisis. Its importance and urgency cannot be overemphasised.

The banking union comprises two main parts. One is the Single Supervisory Mechanism (SSM), which is scheduled to start operating at the ECB in Frankfurt, at the earliest 12 months after the adoption of the regulation. The second part is the Single Resolution Mechanism (SRM), which is a Siamese twin. The ECB cannot exercise this task as it will undertake the analytical part of supervision. A separate authority is needed; perhaps one that is attached to the ESM, for the resolution task as it implies a distributional impact which belongs to the Executive prerogative. Still, close cooperation is warranted with the SSM and DG Competition.

What is also clear is that the resolution body needs to operate at the same level as the supervisor, i.e. the European level. This becomes even more obvious amid the potential need to deal with cross-border operating banks.

The SSM will be a single supervisor for all banks established in the euro area, plus those banks established in the EU countries which have entered into a close cooperation with the ECB. So it will have a truly European focus.

It should create a level playing field for the European banking industry and remove any national biases or supervisory forbearance, and prevent the hiding of bad assets – or even leniency – towards so-called “national champions”, a phenomenon that might have become more acute during the crisis. It is a myth that such champions were in the interests either of domestic economies or of national taxpayers. But the SSM will go well beyond that: it will result in the elimination of asset and liability matching on a national level that has done so much harm.

***How will the Single Supervisory Mechanism function in practice?*** There will be a two-tier system of banks.

The banks considered to be systemically important, about 130 of them, will fall under the direct supervision of the ECB. But all other banks, while remaining under national supervision, will not be excluded from the ECB’s supervisory reach. In fact, national authorities will have to abide by ECB regulations, guidelines and general instructions. Hence, they will be subject to the ECB’s broad oversight mandate.

Yet the boundaries between the two tiers can also be adjusted if the need arises.<sup>[5]</sup> The ECB may decide at any time to exercise direct supervision over any other credit institutions. This will ensure the consistent application of supervisory standards as well as adherence to the guidelines and instructions issued by the ECB.

The ECB will be responsible for the functioning of the SSM. In practice, the ECB will rely heavily on existing national supervisors: their expertise and “proximity” to the supervised banks are essential for the SSM to be effective. No domestic aspect or concern must be overlooked. Even in the case of the systemic banks that will be directly supervised by the ECB, national supervisors will still be involved in on-site inspections. In fact, there will be joint supervisory teams.

The assignment of supervisory responsibilities to central banks mirrors the prevailing consensus among experts and academics.<sup>[6]</sup> There are many synergies between monetary policy and banking supervision, and in our case there are benefits from sharing micro and macro-information on monetary policy, bank supervision, and the oversight of payment systems.

Moreover, an important lesson from the crisis is that there can be no price stability without financial stability. Most of the time, monetary policy and financial stability measures work in harmony. Still, there are concerns. There are several things we need to do, notably, steer clear of the risks, as the ECB will be the prime liquidity provider for these banks; establish clear safeguards against any potential conflicts of interest between the various ECB functions as they could give rise to reputational risks. And at the same time we need to reduce costs.

The SSM also represents a huge logistical challenge for the ECB. We are working hard on this and are well aware that the rewards may be considerable. It is requiring a lot of preparation at many levels including:

- selecting highly skilled staff – many experts are already coming from national supervisory bodies;
- drawing up the final list of systemically important banks that will be directly supervised;
- harmonising reporting requirements; working out procedures that will govern the SSM's relationship with national supervisors; and
- preparing to review the quality of banks' assets, including legacy assets.

Let me add on the last point: Such a comprehensive assessment is needed before the SSM becomes operational. This could be organised in a coordinated endeavour where the workload is shared between by the centre and the national authorities. Calling upon external experts, under the strict control of the SSM, will increase the credibility of the balance sheet exercise because of the impartiality of third parties. Moreover, their expertise in certain areas will add great value. The scope of their involvement might not extent the significant banks, however.

First coordination has already started with the European Banking Authority (EBA) which in the past looked upon the resilience of banks under stress scenarios. The SSM could undertake the asset quality review in the third quarter of this year until the first quarter of next year, and then in close cooperation with the EBA, conduct a stress test. This along with the balance sheet assessment will be a major component of the comprehensive assessment. The outcomes of the

balance sheet assessment will also be an important input for the stress tests. The combined results of both exercises could be published by mid-2014, just before the SSM is scheduled to become operational.

As always in life, there is no such thing as a free lunch. The question arises: who will pay for financial stability and, above all, who will pay in the event of a banking resolution? There are two types of “costs”: operating costs incurred in normal times and losses sustained in times of crisis. As for the operating costs, European supervision will be financed by fees to be levied on banks. However, there will be efficiency gains from avoiding the duplication of services (national and European), so additional cost burdens for the financial industry will be contained.

What happens if a viable bank lacks capital? Such a bank, wherever it is based in the euro area, should first try to raise fresh capital from its shareholders or in the market. If it is unable to do so – for example due to unfavourable market conditions – fresh funding should be provided from a European recovery and resolution fund that is financed by all banks.

Such a fund should also help with resolution, for instance, to capitalise a bridge bank that is later sold on the market. Bailing-in of stakeholders will also play an increasing role to cover the cost of resolution. During the crisis we have seen the full spectre from mainly bailing-out banks with taxpayers' money and bailing-in even depositors. A reliable framework is needed to guide investors and savers. Therefore, the pecking order of a broad scope of bail-in instruments needs to be defined. The list of exclusion should be limited. The Bank Recovery and Resolution Directive (BRRD) currently being negotiated should clarify in particular the positioning of unsecured depositors in the cascade. It is of crucial importance that an agreement on the BRRD is reached in a timely manner to have a resolution and recovery framework in place before the SSM starts operating.

Only as a last resort should rescue funds be temporarily drawn from the ESM. To ensure fiscal neutrality, a loan to the European recovery and resolution fund should then be repaid *ex post* via levies on viable banks, and of course, the proceeds from the re-privatisation.

Another rationale for the SRM as a separate entity is that a supervisor cannot give objective verdicts on the viability of banks if then these banks can only be closed in a disorderly way. That, in turn, could trigger contagion and endanger financial stability. In other words, if banks cannot be resolved in a disciplined manner – known in advance and agreed upon – we could drift into supervisory forbearance, evergreening and zombification of companies as well as the banks themselves.

Hence, a resolution mechanism is essential for repairing financial markets. The capacity of the banking sector to absorb risks will increase, which is currently the bottleneck of loan provision to the real economy.

***To sum up what's next:*** the banking union consisting of the SSM and the SRM will contribute to financial soundness, stability and resilience. All this would help to restore the proper transmission of monetary policy. The current very accommodative monetary policy stance could reach those it needs to reach unhampered. Correspondingly, the need for unconventional measures would diminish rather than increase. A single supervisor without a resolution counterpart, however, would push the central bank into ever more risk-taking to ensure financial stability, thus even threatening the independence of monetary policy.

**What remains to be done?**

The crisis has been – and still is – a wake-up call for the euro area. Initially, some stressed countries were largely in denial about the need to tackle their imbalances. Precious time was wasted, and that exacerbated the doom-loops. Then, things started turning around in mid-2010. A new political economy is within reach. But in the longer-term, what else do we need for the viability and prosperity of the euro area?

We need to firm up the progress on the fiscal union, the political union and the economic union. Several elements of the fiscal union are ready. I listed them a few minutes ago: they need to be transposed into national law, and adhered to at every level of government (i.e., national, regional, provincial and so on).

Concerning “genuine political union”, our institutions also need to adjust to the higher level of integration that constitutes the monetary union. While on the intergovernmental EU wide level the Council has a counterpart on the euro area level, namely the euro group and the Euro Working Group, the executive arm of the supranational EU level, the Commission, and the legislator, the EU parliament, still lack an equivalent for the euro area.

Yet, the principal building ground of the new euro area framework is the economic union. In the long term, we need euro area countries to become more flexible, open and to remain relatively synchronised. This would increase shock absorption, improve resource allocation, remedy the current heterogeneities, harmonise the transmission of monetary policies, and boost growth potential, thus enhancing the resilience of the euro area as a whole. This implies a need for deep changes in our societies.

Allow me to point out that over the last few years the ECB has not only been a guardian of stability and among the most interested observers of the various deficit and imbalances procedures, but we have also raised awareness of the need for profound transformations in our political economy and in our societies. We have been advocates of change. ***In my view, this is our most important unconventional measure, but it will never be able to replace the self-responsibility of countries.***

In one respect, solving the sovereign debt crisis of the euro area remains a supremely national affair: namely, finding a consensus on, and domestic support for, new social contracts among all national constituencies. The new political economy of the euro area and the “four unions”, i.e., what we are calling the new euro area framework, can provide a sheltered environment for reforms and sustainable domestic social contracts.

In most of the stressed euro area countries this still requires tough choices across the generations and over time: e.g. education versus pension entitlements, infrastructure versus healthcare, research and development versus defence, and so on. Strengthening of tax administrations and treasury systems, expenditure control, privatisation will also be crucial. Reducing the costs of bureaucracy will matter more than ever across the euro area. There are varying needs for true innovation clusters à-la-Silicon Valley, as well as investments in scientific and technical education, research and development, encouragement of “angel investments”, and grassroots and sustainable banking. Labour markets need to become inclusive and fair in every country, while encouraging labour mobility, in particular in a monetary union. Greater competitiveness and sustainable growth of the whole euro area will then follow.

**To sum up what still needs to be done:** each euro area country needs to find its own trade-offs and support from its national constituencies. There might not be a single approach fitting all. No “pact” can force such transformation through, and no monetary policy measure – however unconventional – can replace it. Such “holistic” national therapies are

inescapable: without them, no change in the euro area's political economy and governance, or financing facility can be sustainable.

The tensions and inequalities are clear for everyone to see: we can no longer postpone what should already have been addressed. The new euro area framework is an opportunity.

### **Some final remarks**

All currency unions evolve in their early years. Their institutions adapt to changing circumstances, as we saw for example in the US, and several federal states in Europe and even in the UK. The idea of Europe's Economic and Monetary Union (EMU) has evolved over decades. The euro area envisaged in the Werner Report of 1970 was ahead of its time, but planted important seeds. The Maastricht Treaty was a milestone and the most that Europe could have achieved 20-25 years ago, but that was not enough. There were various flaws in EMU's design and governance. In retrospect, systemic risks were partly endogenous. We have learnt the hard way from our errors, and fortunately there are still a lot of strengths in Europe/euro area.

The euro – and thus price stability and the future banking union – can provide a shield from outside shocks, secure the benefits of a credible world currency, and contribute to strengthening the single market and fostering internal stability. This structure would have been unimaginable only five or six years ago: yet it might not suffice unless it is accompanied by national reforms and new social contracts that in some cases have been postponed for decades. The new euro area framework is being rebuilt to be viable and to last.

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<sup>[1]</sup>For a chronology of the crisis see also Drudi, Durre and Mongelli (2012) "The interplay of economic reforms and monetary policy: the case of the euro area", ECB Working Paper No. 1467 at <http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1467.pdf>

<sup>[2]</sup>Mongelli (2013) "The mutating euro area crisis: is the balance between "sceptics" and "advocates" shifting?", ECB Occasional Paper No. 144, at <http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp144.pdf>

<sup>[3]</sup>See also: Shambaugh, J.C. (2012), "The Euro's Three Crises", Brookings Papers on Economic Activity, Spring. And Schoemaker, D. (2011), "The financial trilemma", *Economic Letters*, 111 (2011), pp. 57-59.

<sup>[4]</sup>"Four Presidents" of the European Council, European Commission, Eurogroup and the ECB. European Council (2012), "Towards a Genuine Economic and Monetary Union", June [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/131201.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131201.pdf)

<sup>[5]</sup>See also "The Banking Union - a European perspective: reasons, benefits and challenges of the Banking Union", a speech that I delivered at the seminar "Auf dem Weg zu mehr Stabilität – Ein Dialog über die Ausgestaltung der Bankenunion zwischen Wissenschaft und Praxis" organised by Europolis and Wirtschaftswoche, in Berlin on 5 April 2013.

<sup>[6]</sup>International institutions and fora such as the International Monetary Fund or the Basel Committee on Banking Supervision (in its Core principles for effective banking supervision) clearly stress the advantages of an independent supervisor.