THIRD DG ECFIN ANNUAL RESEARCH CONFERENCE: "ADJUSTMENT UNDER MONETARY UNIONS: FINANCIAL MARKET ISSUES."

Adjustment under Monetary Union: The Financial Sector Challenge

Keynote Remarks by Klaus Regling

Ladies and gentlemen, I am delighted that you have been able to join us at this third DG ECFIN Annual Research Conference.

Like any service organisation, we try to be responsive to our clients! We have picked a subject for this event which a number of you suggested when you were here last year: "Adjustment under Monetary Unions: Financial Market Issues." At first sight, it sounds straightforward: improving integration as part of Europe's single market. We view our financial market agenda in the Commission as a key route to stronger growth and enhanced adjustment. But as with all grand topics, the devil is in the details. What precisely are the links between financial integration the *adjustment process* under monetary union? This is an important question, and more complex than it may seem.

In these remarks I would like to highlight some issues that, from a policy perspective, were on our minds in structuring the conference around your papers. These concern
(1) the role that financial integration can play in a well-functioning monetary union;
(2) the challenges it can pose, if not well-managed; and
(3) some implications for policy, if we are to reap the full benefits of integration.

1. The contribution of financial integration

There is a wide literature on links between the financial sector, economic growth, and the sustainability of imbalances. But less is written about the ways in which financial markets can foster *efficient adjustment*. So it is timely to focus, in this conference, on the channels through which financial integration under monetary union can contribute to the adjustment process. How can it enhance the euro area's resilience in the face of shocks, and the speed with which resources can be redeployed in support of growth?

a. Resilience in the face of shocks

The euro area economy has responded relatively robustly to common shocks. We have lived through the dotcom bubble, 9/11, the recent hike in oil prices, the emergence of wide global imbalances – and thus far the monetary union has served its members well. People quickly forget that such shocks often led to intra-European currency turmoil with negative growth effects in the 70s, 80s and 90s. With the euro, this cannot happen. And despite all the shocks we have experienced, inflation and inflation expectations remain low today. Confidence in the euro is strong. But we should not be complacent about the future. Moreover, we need to pay attention, in particular, to channels that can influence adjustment to country-specific shocks.

One key way in which financial market integration can support economic adjustment is by deepening the resilience of the euro area economy through several routes:

- **Portfolio diversification:** A hallmark of today's financial sector is that it disperses claims to a broader range of portfolios, so that risks are better spread. The expansion of hedging mechanisms (while not without risks) has also been key in ensuring that the system is robust in the face of shocks. Moreover, the expansion of derivative markets has increased the depth of information on market expectations, providing a richer feedback to policy-makers as they seek to embed economic and financial stability.

- **Institutional diversity:** A diversified financial sector is potentially more robust than one resting on a few pillars. Alternative intermediation channels, for example, can avoid the risk that stress in one part of the financial system starves firms or sectors of funds at a time of adjustment stress.

Both these elements also help make monetary transmission mechanisms more efficient and stable, since the impact of interest rate impulses is spread more evenly. They impart resilience to the system during adjustment to shocks. But several additional mechanisms have gained increasing attention, in part due to researchers present at this conference. They are particularly important in relation to monetary union, because they represent ways in which financial integration can facilitate adjustment to country-specific shocks. In other words, they can improve the critical process of inter-country adjustment under monetary union. In my view, the role of the financial sector here is more important than many believe:

- **Stabilization through income smoothing:** Financial integration holds great potential to smooth incomes through cross-border asset diversification, and thus stabilize the economy in the face of shocks. Empirical work in the United States can help us understand this better: on some estimates, two-fifths of the income effect from local shocks is smoothed away through asset holdings across state lines. I must refer here to the seminal work of Bent Sorensen, who is participating in this conference, among others. This risk-sharing is an invisible centrepiece of resilience in the U.S. economy. It is beginning to emerge in the euro area, but we are truly at the start of the path. It is particularly important in a context where there is no large federal budget to play a stabilization role through transfers to Member States.

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- **Dampening the negative effects of localised financial shocks:** Integration of markets can also support smooth adjustment on the side of suppliers of capital. I was very struck by recent research at the IMF suggesting that securitization of the U.S. national mortgage market may have halved the amplitude of local real estate cycles by diluting “credit crunch” effects in the downswing. Cross-border ownership of banks can also help dampen such effects. The paper by Landon-Lane and Rockoff at this conference also highlights the fact that asymmetric shocks in the United States have been dampened since the 1940s by integration in financial markets and the role of the Federal Funds rate. They also make clear how monetary union *preceded financial union* in the U.S.

b. Resource allocation during adjustment

Adjusting well to shocks means having a system that is not only resilient but also re-allocates resources efficiently across sectors and firms. When the euro area is hit by supply shocks, or when members experience country-specific shocks, for example, the financial sector’s role is crucial in assuring a rapid regeneration of productive capacity and growth. In the United States, a high proportion of the adjustment to a regional shock takes place when labour moves. We may underestimate the scope for labour mobility in Europe, but it will probably never take place on the US scale. Adjustment will be more via skill, wage and price adjustments in euro area members. It is critical that capital moves fluidly to take advantages of such shifts, creating new businesses and new jobs. The impact of globalization on traditional industries is just such a case. And of course, we also need good systems for training, and efficient processes for the entry and exit of firms to support this.

The benefits of risk-sharing are important here, too. By insuring incomes against asymmetric shocks they raise the willingness of agents to commit to specialization. This can be a strong force helping to reshape the industrial and commercial landscape of the euro area, and the EU more widely.

In other words, there are many important ways in which a strong and integrated financial sector can help ensure smooth adjustment in our monetary union.

2. Challenges and risks in financial integration

But officials are paid to worry, and I will not disappoint you: financial integration brings risks too. That is why so much attention has been devoted to financial stability analysis, supervisory techniques and co-operation, and the strengthening of payments and clearing systems – fields in which some participants here, such as Alberto Giovannini, Peter Praet and Sean Berrigan, have been very active. I would like to highlight four areas in which integration can pose challenges for policy-makers.

First, the challenges of greater market complexity. Derivatives and complex instruments package risk in new ways, and as a result we may not have a sure feel how shocks will propagate in the economic system, and where the ultimate risks will lie. This calls for continuing analysis and market surveillance. In addition, when shocks do hit financial markets, the more opaque pattern of risk dispersion means that central banks may need to respond with global liquidity injections. We have seen this over the past decade: central banks have repeatedly saved the day. But these actions lift all ships on a common tide. This raises important issues about market discipline as it affects the management of financial institutions. One needs to beware that just “picking up the pieces” after asset busts may, over time, ratchet up the moral hazard in the system. The paper by Adalid and Detken is of potential relevance here.

Second, the changed nature of market discipline over policies. The response of financial markets to policy is significantly different under monetary union. The most striking aspects of this, of course, are the elimination of exchange risk and the ease of financing imbalances in highly integrated markets. In this environment, and a global setting of low risk premia, signals to policy-makers may be very muted, for example, when fiscal policy moves off track. Moreover, the fact that public and private sector imbalances are easier to finance is only an advantage if foreign savings are well-used. The paper by Kalemli-Ozcan, Reshef, Sorenson and Yosha considers some factors that drive such flows to economies where productivity growth is high.

Third, a risk that distortions could be amplified. Flexible and integrated financial markets will tend to amplify both favourable events and distortions. If we make real estate borrowing tax deductible, for example, we run risks of distorting resource allocation on a major scale. This risk is important in the convergence context among others. We also see in the papers by Langedijk and Roeger and by Fagan and Gaspar how monetary union can accelerate financial growth in converging economies, including a relaxation of credit contraints on households. This a potential gain, but with risks. If immature institutional structures or weak governance inhibit lending to firms, then the pattern of borrowing may be quite unbalanced. The paper by Rinaldi and Sanchis Arellano explores links between household borrowing and bad loans.

Fourth, the evolving nature of systemic risk. We need to consider to what extent the inter-country adjustment process under the euro subtly affects the nature of systemic risk. Lengthy inter-country adjustment cycles may lead to changed risk patterns in credit and asset markets, especially if weak fiscal or structural policies tend to increase overshooting in real exchange rates. Sudden and sharp market crises are less likely, with the elimination of national exchange rates; but the countervailing risk is of slow-burning “growth crises” of the kind that Portugal has experienced. Policy spillovers are also greater in integrated financial markets, and macroeconomic and structural policies become even more strongly matters of common concern.

The financial sector has a capacity to respond to news; articulate expectations; transmit, buffer or amplify shocks, that is an order of magnitude faster than other markets or official channels. So we need to shape policies that will steer expectations successfully and pre-empt stress – staying ahead of financial markets in that sense.

3. Policies to tap the full gains of integration

This setting puts a premium on effective policies and on policy co-ordination. It underscores the role that the eurogroup can play in ensuring that we benefit fully from financial integration – including to enhance adjustment mechanisms in the euro area. Each of the main branches of policy can contribute to this, including those that fall under the responsibility of Member States.

- ***Fiscal policy is the bedrock on which financial stability rests.*** It is crucial to maintain discipline in the face of changed market responses, in line with the reformed Stability and Growth Pact. When Member States experience a strong financial boom, it will be especially important to be vigilant that the underlying strength of the fiscal position is not over-estimated. Experience in the early years of monetary union underlines the risk of allowing the fiscal stance to ease inadvertently as a result of transient revenues from asset market gains; a tax-rich composition of GDP (with strong consumption and lower net exports); and a tendency to upgrade estimates of potential growth pro-cyclically. Also, if stresses emerge in the financial system or real economy, budgets must be well-placed to underpin stability.

- ***Structural policies are also very important if resource allocation is to benefit from more integrated financial markets.*** These policies interact with financial integration in several ways. Both favourable and unfavourable structural features may be amplified by integration, so distortions need to be addressed – including in the microeconomic side of fiscal policy, as I noted. Flexible labour and product markets will favour smooth adjustment to shocks, with the benefit of financial sector support. And more specifically, under monetary union, flexible real sector markets will help ensure that asymmetric shocks to euro area members trigger timely adjustment through shifts in competitiveness, swiftly dominating any perverse effects in real interest rates and asset markets. These adjustment themes are explored, in various ways, by Bergman, Hoeller and Giorno, and Langedijk and Roeger.

- ***Policies towards the financial sector need to push integration forward, including to foster efficient adjustment.*** This means implementing the Financial Services Action Plan through national legislative measures; ensuring supervisory convergence; and giving assurance to market users through investor and consumer protection. Competion policy plays an important role too, and the paper by Carletti and Hartmann explores its effect on mergers in an interesting manner. Supervisors also need to take due account of changes in systemic risk as they evaluate institutions' control systems and financial soundness. We need to be careful that, in parallel, we take all opportunities to strengthen market discipline and supervision, so that we do not increase moral hazard. This implies adequate co-ordination in financial policies to set the right incentives and ensure that failures can be handled smoothly. An important issue in integrating euro are markets is to ensure that supervision and liquidity support keep pace with ever more complex linkages across functions and borders. The spread of area-wide financial institutions will pose new challenges to supervisors. Eisenbeis and Kaufman certainly provide some stimulating proposals in this area.

With the right degree of policy discipline and co-ordination, we can leverage the role of the financial sector in fostering smooth and growth-oriented adjustment. And that role, as I have stressed today, is especially critical in our monetary union – where there is not a large federal government, and where labour mobility does not serve as an adjustment channel to the same degree as in the United States.

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Well, ladies and gentlemen, today and tomorrow you have the opportunity to work through these issues together in a systematic manner – from key policy questions to analytics of the real side; then issues on the financial side; cross-border integration; and lessons from other monetary unions. And at the end you have a distinguished panel to talk about priorities for the financial sector in an adjustment context. We owe a debt to all those who have played a part in conceiving and organising this event – especially Lars Jonung, Mary McCarthy and Max Watson. I wish you excellent discussions, and I look forward to the conclusions that you reach between now and Friday lunchtime – which can be very useful to us as we pursue our policy work in ECFIN. We need your input, and will use it! Thank you very much.