Resilient Europe – Tackling the financial crisis

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1. Introduction

Modern economies need well-functioning financial systems. If the right incentives are in place, financial systems allow agents to transfer resources where and when they are most needed. This in turn allows entrepreneurs to finance projects with positive net present value. The overall growth potential of the economy is enhanced, creating in the process jobs and wealth. There is by now a large body of academic literature showing the existence of a positive, causal relationship between financial development and economic growth.[2]

Well-functioning financial systems are also a necessary condition for central banks to be able to carry out their monetary policy. In normal times, monetary policy is implemented by steering the very short end of the money market curve, indirectly affecting in this way the whole term structure and the cost of funding of the economy. In exceptional times – as the current ones when the lower bound is reached – central banks use non-standard measures to directly impact the longer end of the term structure.

In the euro area, the European Central Bank faces the additional challenge of implementing its monetary policy in a fragmented financial system. Well-integrated financial systems are necessary for a uniform transmission of the monetary policy stance. This explains the strong focus of the ECB (and other European authorities, like the Commission) to promote and closely monitor financial integration. Since more than 10 years now, both the ECB and the European Commission publish annual reports on the state of financial integration in Europe.[3]

The ECB put in place a whole series of non-standard measures to cope with different symptoms of the crisis and to bypass malfunctioning of different parts of the financial system. A quick and cursory list includes:

1. Move to fixed rate full allotment operations, with expansion of available collateral;
2. Longer term refinancing operations (LTRO) with maturity extension up to one year;
3. Launch of the Securities Market Programme (SMP);
4. Very long term refinancing operations (VLTRO) with maturity up to four years;
5. Outright Monetary Transactions programme (OMT);
6. Extension of the Asset Purchase Programme (APP), which now includes ABS, covered bonds and government bonds from all euro area countries.

[1] The views expressed here are my own and do not necessarily reflect those of the ECB or the Eurosystem.
[2] The idea to link finance and growth in a causal way traces back to Schumpeter (1912) and later Goldsmith (1969) and McKinnon (1973), but the modern impetus for studying the nexus is usually attributed to King and Levine (1993). See also Manganelli and Popov (2015) for more recent evidence.
[3] See "European financial stability and integration report", April 2015, European Commission, and "Financial integration in Europe", April 2015, European Central Bank.

The ECB has done a lot to sustain the financial system, but it should be clear that it can only deal with the short term symptoms of the crisis. Improving the long term resilience of the financial system requires addressing the deep causes of the crisis. The title of this panel is "Resilient Europe – Tackling the financial crisis". The looming question is how to make our financial system safer and more stable, while still promoting economic growth. Actions have been taken on many fronts in Europe in the past few years. In my remarks, I will focus on the ongoing construction of the Banking Union, highlighting how, by fixing a few market failures, it will increase the resilience of our financial system.

2. How the Banking Union is tackling market failures in the financial system

In standard economics textbooks, government intervention is justified on the basis of market failures. The crisis provided plenty of examples, and they essentially can be reduced to negative externalities and asymmetric information problems. Negative externalities are associated with systemic risk (due for instance to too-big-to-fail) and with the bank-sovereign nexus. Asymmetric information stems from the lack of transparency, opacity and complexity of banks' balance sheet.

There is one simple way to make the banking system safe, and that would be to adopt a so-called "narrow banking" model.[4] In its most extreme form "narrow banks" issue demand deposits which are fully backed by cash or central bank reserves. The financing of the economy would be left to "investment funds" that can make risky loans to firms and households, but are financed only with equity and long-term debt. By its very nature, narrow banks would be stable and not subject to runs: there is no point in running a bank which holds 1 euro of cash for each euro of deposits. Externalities and asymmetric information problems would be solved, at least for the banking sector.

However, leaving aside the non-trivial issue of how to manage the transition from the current system to the new one based on narrow banks, it is not clear to me that this would lead to a better outcome for the economy as a whole. First, one of the key functions of the banking system, which is to provide maturity transformation, would be, to say the least, impaired. Second, the financial system as a whole would not necessarily be more stable than it is today. The new investment funds can easily be subject to financial market runs, with dire consequences for the financing of the economy. Third, and perhaps more importantly, prohibiting financial institutions from issuing risky short-term debt will not make risky short-term debt disappear from the economy. It will likely reappear in the unregulated shadow banking sector.

It therefore seems reasonable to adopt a more measured approach to manage the overall risks of the financial system, based on robust capital and liquidity requirements, together with well-designed supervision and resolution mechanisms. And this is, in fact, the approach taken with the Banking Union in Europe.

I will argue that the Banking Union will help severing the bank-sovereign nexus, will internalise potential spillovers of macro-prudential policies, will address head on the negative externalities associated with systemic institutions, and is putting in place incentives to mitigate asymmetric information problems in the banking system.

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[4] The classic Chicago plan is in Douglas et al. (1939). Related recent proposals are, e.g., Benes and Kumhof (2012) and Kotlikoff (2010).

The Single Supervisory Mechanism and coordination of macro-prudential policies

One important lesson specific to Europe, highlighted by the crisis, has been the close connection between banks and sovereigns. This is worrisome not only because sovereign and bank fragility reinforce each other, but also because of their impact on the real economy. Empirical evidence from the euro area sovereign debt crisis shows that banks in non-stressed countries with exposure to distressed sovereign debt lend less to the real economy. To give you an idea of the magnitudes involved, one study finds that after the third quarter of 2010, German, French and Dutch banks with substantial holdings of sovereign debt from stressed countries reduced lending by more than 20% relative to banks with only marginal holdings. Results are even stronger when looking at banks from stressed countries.[5]

The idea of a banking union in Europe stemmed from the realisation that the vicious loop between banks and sovereigns could be broken only by recapitalising banks at European level. The Banking Union rests on a common supervision, a common resolution mechanism and a common deposit insurance. The common supervision is already in place since November 2014, when the Single Supervisory Mechanism has officially started its operations. The role of the SSM is not only to ensure the safety of every single financial institution, but also to ensure the stability of the system as a whole. Macro-prudential policies promote financial stability by raising the resilience of the financial system to shocks and by controlling the build-up of imbalances and smoothing the financial cycle. Research shows that several macro-prudential measures – such as caps on debt-to-income and loan-to-value ratios aimed at borrowers or limits on credit growth and capital ratios aimed at financial institutions – are effective in reducing asset growth and containing the risk taking of banks.[6]

One important issue in Europe which will occupy the agenda of policy makers for some time is that of coordination of national macro-prudential policies. In fact, some measures, such as loan-to-value and debt-to-income ratios, have remained in the realm of national authorities. However, there is increasing empirical evidence showing that stricter regulation of banks in the home country affects banks's behaviour in foreign countries.[7] For instance, an empirical paper looking at foreign-owned banks in Central and Eastern Europe finds that if regulatory measures limit the demand for loans in one country, cross-border banks will adjust their lending to other countries. More precisely, higher restrictions on non-core bank activities (like bank involvement in securities markets, insurance, real estate, ownership of nonfinancial firms, etc.) or higher minimum capital requirements result in lower lending standards by cross-border banks in foreign markets.[8]

In the euro area it is therefore essential to ensure a level playing field in the implementation of the regulation and supervision. In fact, part of the ECB tasks in its new role as supervisor is to ensure a coherent implementation of these measures, taking spillovers into account.

The Single Resolution Mechanism and bail-in directive

The Banking Union will also tackle the negative externality associated with the issue of too-big-to-fail with the Single Resolution Mechanism (SRM). It is well known that bank resolutions are often costly, complex and time-consuming. In the absence of alternative mechanisms to put them into orderly

[5] See for instance Popov and van Horen (2013).
[6] See for instance Altunbas, Marquez and Manganelli (2014) and Claessens, Ghosh and Mihet (2014).
[7] Aiyar, Calomiris, Hooley, Korniyenko, and Wieladek (2014).
[8] Ongena, Popov and Udell (2013).

resolution to restore their viability, governments have to bail out intermediaries using taxpayers' funds. While government support may be successful in avoiding financial contagion, it strains public finances. More importantly, the expectation of publicly funded bailouts fuels moral hazard behaviour and distorts incentives. No matter how skilful the supervisors and no matter how effective the macro-prudential toolkit, it is inevitable that other financial institutions will eventually run into trouble. It is therefore necessary to make sure that banks can be resolved in an orderly manner, without posing threats to the stability of the financial system and to minimum expenses for the taxpayer. The SRM will ensure that this will be the case, thanks to its independent authority, with the power to restructure banks using resources from a centralised fund.

The SRM has been complemented by the Bank Recovery and Resolution Directive (BRRD), who gives powers to the SRM to resolve banks by bailing-in shareholders and other banks' liabilities, without accessing the resolution fund. This represents an additional step in the direction of imposing market discipline, by addressing market failures associated with asymmetric information stemming from complexity and opacity of banks' balance sheets. Banks, especially those difficult to resolve, have benefitted from an implicit public bail-out subsidy, which effectively reduced their cost of funding. By redistributing risks from taxpayers to bank debt-holders and shareholders, the BRRD should adjust the cost of funding for banks to truly reflect the risk and complexity of their balance sheets. It is difficult to assess the impact of the bail-in directive, because the regulation has come into force in different waves and market participants may have priced in its effects at different points in time. In internal, unpublished research at the ECB, using secondary market data on bond yields for France, Germany, Italy and Spain, we find evidence of a narrowing of the spread between subordinated and senior debt having taken place immediately after the Cypriot bail-in. The bail-in of Cypriot banks was arguably a clear signal that public authorities would have been less prone to bail out banks in the future, and one would expect a re-pricing of less risky debt relative to the more risky one.

3. Conclusion

Modern economies thrive also thanks to well-developed and regulated financial systems, with properly functioning market mechanisms. Those who take risks should be made aware of the risks they are taking, reaping the benefits in case of success and bearing the consequences in case of failure. If losses, instead, are spread to taxpayers or other economic agents, resources are misallocated and the potential long-term growth of the economy is reduced. I have tried to argue how the ongoing construction of the Banking Union in Europe is helping to improve the functioning and resilience of our financial system, by addressing important market failures.

Still, the recent crisis has shown that more needs to be done to foster the European construction. Eventually, as foreseen by the Five Presidents' Report, the European Union may arrive at a full fiscal and political union. It may take some time to get there. Until then, the completion of a well-functioning Banking Union is a promising step forward.

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