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The future of the euro area – the perspective of central banks

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It has been almost 20 years now since the euro has been introduced. The common European currency plays a vital role for the single market. The international division of labor is an important driver of growth and welfare. Globally, Europe is the largest economic area. A large share of Germany's and France's foreign trade goes to other European countries. Not only the real economies, but also financial markets and payment systems are closely intertwined across borders.

Many of these achievements are currently being debated – along with the responsibilities of the national and the supranational level in Europe. The reforms of the past ten years have remedied many shortcomings. However, the process of renewing European institutions is still ongoing.

At the same time, geopolitical risks have increased. Multilateral agreements and economic integration are being questioned openly. This comes, not least, with economic costs, and it might create incentives to take measures leading to a fragmentation of markets, including markets for capital and financial services.

To address these challenges, a common European response is needed. The key is a constructive and unprejudiced dialogue in Europe that aims at finding solutions. Given their analytical strength, central banks can contribute to such an informed dialogue and to reduce the influence of "fake news".

The Banque de France and the Deutsche Bundesbank cooperate in a number of ways within the Eurosystem. Therefore, we would like to take a joint perspective that comprises the following elements: the achievements of the reforms that have been implemented in the euro area should not be played down, we have to learn from past experiences, and we should enhance dialogue on the future of the euro area.

1 Not playing down achievements of reforms

Current discussions on open issues in Europe and potential risks might create the impression that progress since the recent crisis has been insufficient and that flaws in the

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institutional setting have not been identified. However, the opposite is true. Fundamental shortcomings of the financial system and institutional weaknesses in the currency union have been identified and addressed. Discussions on future steps to be taken should, therefore, start with a stock-take of what has been achieved so far in order to identify any need for further reforms.

The crisis has shown that the dynamics of debt and economic fundamentals need to be aligned. This holds true for the private and public sector sector. Also, no country and no financial system is immune to distortions and misaligned incentives. In economies as deeply integrated as the euro area, consequences of such misaligned incentives easily spill over across borders.

Important lessons have thus been drawn from the financial crisis.

With regard to fiscal policy, stricter rules on deficits and debt were established, including the “six-pack”, the “two-pack”, and the Fiscal Compact. The European Commission was put in charge of monitoring macroeconomic imbalances through which distortions spill over internationally.

The supervision of banks, insurers and financial markets has been strengthened at the national and the European level. In a first step, European Supervisory Authorities were established, and the “Single Rulebook“ was implemented to harmonize the legal framework for banking supervision. Stricter international rules for banks have thus been implemented at the European level. In a second step, the Banking Union was launched in 2014 with the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). The implementation of the European Banking Union is an important step towards risks in the banking sector being supervised at the supranational level. It shifted responsibilities from the national to the European level.

Along with the reform of traditional (banking) supervision, macroprudential policy was established as a new policy field. Macroprudential surveillance focuses on the stability of the entire financial system rather than on individual banks. Thus, it aims at reducing the probability that an adverse shock could endanger the stability of the financial system with potentially harmful effects on the real economy. Safeguarding financial stability is a national

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responsibility. Given the close integration of European financial markets, however, macroprudential policy is coordinated closely at the European level.

Currently, first experiences with macroprudential measures are being gathered. Take, for example, measures recently announced in France on large exposure limits and on counter-cyclical capital buffers.[1]

But even the best set of rules cannot prevent crises from happening. Therefore, a framework for dealing with crises situations was created with the European Stability Mechanism (ESM). Mechanisms to deal with insolvent banks were established. Neither existed prior to the crisis. During the crisis, decisions on how to allocate losses had to be made *ad hoc*. At the national and the European level, new institutions handling the restructuring and resolution of insolvent banks were created – the Single Resolution Board and national agencies.

These reforms contribute to the reduction of incentives for risk-taking, they enhance the resilience of the financial system, and they strengthen the European institutional framework. Yet, some reforms have not yet been completed or fully implemented. Many of the new rules and institutions are still “untested”. Therefore, we must learn from past experience and address any shortcomings.

2 Learning from past experience

An independent monetary policy depends on stable financial markets which are resilient with regard to financial crises. A structured evaluation of reforms aiming at the stability of financial markets and at preventing that sensible reforms are rolled back is thus important.[2] The risk of a roll back is imminent whenever achievements of the reform agenda are insufficiently visible and whenever unintended side effects occur. Like in many other areas, the costs for the affected institutions are more visible in the short-term than the benefits of financial market reforms for society.

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Increased reporting costs or increased funding costs, for instance, can be measured more easily and more quickly than a lower probability of future crises and lower costs of future financial crises for taxpayers. Also, reforms might have distributional consequences. Rules for the “bail-in” of creditors are needed, for example, to ensure that incentives are properly aligned – but how should policy react if a bail-in also affects small investors who are not well informed? Intelligent political solutions are needed to deal with potential negative distributional effects.

A structured evaluation of reforms can give answers to these questions. Evaluations aim at assessing the costs and benefits of reforms and to improve – if necessary – elements of the new rules and the new institutional framework. Evaluations emphasize the social costs and benefits of reforms through causal impact assessments.

Dealing with the new bail-in rules is a concrete example of how we can learn from experience. Contrary to what is sometimes suggested by the public debate, the new rules were applied in handling the first cases. Shareholders and some subordinated creditors had to take losses (i.e. they were „bailed in“).[3] At the same time, weaknesses in the institutional framework have become evident, including inconsistencies between national and international rules for dealing with the insolvencies of banks. Also, the decision process was often overly lengthy.

Moreover, experience shows that credible regimes for the recovery and resolution of banks require a public backstop. Otherwise, there is the risk that necessary decisions are delayed and monetary authorities are pressured to assume some of the risks. At the same time, designing a public backstop is – by its very nature – not an easy task. Whenever public money is at stake, there is the risk that public budgets will be overburdened.

Another example of how we can learn from experience regards the processes for dealing with money laundering. In keeping with the principle of subsidiarity, combatting money laundering is a task that had been assigned to the member states. Yet, structures that facilitate money laundering do not stop at national borders. Therefore, with the “5th Anti-Money Laundering Directive”, the European Commission tightened its rules governing the fight against money laundering and strengthened cooperation between national institu-

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tions. Sharing responsibilities between member states and the European level (SSM/ECB) should thus be improved.

Evaluating the effects of reforms is not only about an assessment of existing regulations and recently agreed measures. Rather, it is about identifying and potentially closing potential gaps and weaknesses.

In doing so, evaluations need to take into account that the market environment is changing. Global risks, changing patterns of foreign trade, and new technologies affect price and financial stability as well as payments systems. All this needs to be taken into account when discussing potential regulatory consequences. Based on a French-German initiative, for example, the G20 is currently looking at the risks and opportunities posed by crypto-assets and crypto-tokens.

3 Developing European financial markets

While many post-crisis reforms have focused on banks, developing European financial markets is an important project going ahead. Investments and innovations are needed in many areas of the economy – in response to demographic change and an aging population, digitalization, and climate change. These investments into the future, in turn, require strong and stable financial markets.
In Europe, however, legacies from the crisis still burden the banking sector. In some countries, non-performing loans remain an issue; in other countries, excess capacities and intense competition are putting pressure on margins. This may delay structural change in the real economy which requires a reallocation of resources from shrinking to growing sectors. For the financial sector itself, digitalization implies a significant structural change.

The financial system, at the same time, contributes to risk sharing in an economy. The public debate on the issue tends to focus on mechanisms of fiscal risk sharing, which are politically sensitive. This debate overlooks that there are unexploited potentials for improv-

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ing risk sharing via financial markets – particularly with regard to international risk sharing. Better risk sharing does not imply calling the European bank-based financial system into question. Rather, it is about finding a good mix between debt and equity finance, between financing via banks and markets. This contributes to an improved allocation of risks across the financial system and to its resilience.

This is because profits of corporate firms or of banks automatically accrue to the owners of these firms who, in turn, also bear potential losses. Claims of creditors, by contrast, do not depend on the economic success of a firm, and they bear losses only if the firm in question becomes insolvent.

Equity capital can, in addition, make a special contribution to the financing of young and innovative firms. Despite all the differences between the German and the French financial systems, markets for venture capital remain underdeveloped in both countries, as they are in other parts of Europe.

Which specific measures can enhance the contribution of financial markets to growth, innovation, and stability? The Capital Markets Union – a project which was launched about two years ago – provides answers to this question.

Reforming insolvency legislation and – where relevant – harmonizing rules can contribute to cross-border investments and to dealing with non-performing loans. Minimum harmonization in terms of the collection of collateral and in terms of creditor rights can be useful in this regard, particularly as it would make shifting losses ex post more difficult.

Moreover, the Capital Markets Union can contribute to relaxing financial constraints so that strong small and medium-sized enterprises and start-ups obtain access to finance. International investment can be attracted by harmonizing investor protection legislation within the EU and removing barriers to cross-border mergers and acquisitions.

Central banks in Europe have been supportive of the Capital Markets Union project, as it can contribute to growth while, at the same time, enhancing the resilience and stability of the financial system.

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4 Enhancing dialogue

Explaining reforms implemented so far, assessing their effects, and drawing the right conclusions can succeed only through a dialogue between relevant stakeholders. Communication has a special dimension in the euro area because the euro is a „currency without a state“. The Eurosystem needs to ensure that citizens in all member states are well informed about issues relating to central banks.
Within the Eurosystem, central banks are politically independent and have a clear mandate: ensuring price stability. Together with other institutions, they play an important role in banking supervision and in ensuring the stability of the financial system.

Central bank independence is confined to the mandate of central banks. It must, in turn, be shielded from political interference. This interference can be indirect if, for example, high levels of private or public debt put pressure on central banks to come to the rescue in times of crises and to assume risks. This may, in extreme cases, put price and financial stability at risk.

Stable democratic institutions are the backbone of economic growth, employment, and investment. And they enable central banks to perform their tasks – i.e. to ensure price and financial stability.

At the same time, price stability and financial stability support democratic institutions. These, in turn, need to provide the institutional framework necessary to ensure that central banks can fulfil their mandate and are protected from direct and indirect political interference.

In this sense, central banks are independent, but they do not operate in a political vacuum. Instead, the mandate of central banks is the result of a political decision making process. Within the limits of their mandate, central banks can take the decisions they consider appropriate. This implies, however, that central bank policies need to be explained to the general public, to be transparent and comprehensible. In addition, central banks in the euro area need to maintain a close dialogue with each other.

What are the concrete contributions of central banks to this dialogue?

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Public communication: Over the past decades, central banks have become significantly more open and transparent. There is continuous communication with market participants, policymakers, academics and, not least, the general public via the media.

Economic education: Central banks have, over recent years, expanded their work in the field of economic education and financial literacy. The Banque de France has, for example, set up a museum explaining money and monetary policy (Cité de l'économie et de la monnaie). In December 2016, the Bundesbank has reopened its redesigned money museum. Similar activities across the network of European central banks are highly welcome.

Staff-level exchange programs: Staff-level exchange programs between the Bundesbank and the Banque de France have been in place for several years now. Today, we are glad to welcome 20 German und 14 French participants of such exchange programs to this conference. Ensuring more diversity and promoting equal opportunity employment can further contribute to an improved internal and external dialogue.

Joint projects: The joint spring conference between the Bundesbank and the Banque de France has been a successful form of cooperation between the two institutions for many years now. Many other joint initiatives can be mentioned as well – including the International Banking Research Network[4], a new working group on "Green Finance"[5], and the INEXDA[6] network of research data centers. Employees from many business areas of the Bundesbank and the Banque de France successfully cooperate within these projects. Given the importance of the Capital Markets Union (CMU) for investment and stability[7], Banque de France and Bundesbank will closely work together on the objectives of the CMU

These examples of joint initiatives show that cooperation and coordination pay off. They pay off in terms of an improved understanding of potentially different viewpoints and in terms of finding common solutions, where needed.

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[1] See https://www.economie.gouv.fr/files/files/directions_services/hcsf-en/HCSF_20180611_ _Press_release.pdf

[2] See e.g. http://www.fsb.org/2017/07/framework-for-post-implementation-evaluation-of-the-effects-of-the-g20-financial-regulatory-reforms/ and https://publications.banque-france.fr/sites/default/files/medias/documents/818046_gsa49_web.pdf, p. 5-14.

[3] See e.g. https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Financial_Stability_-Review/2017_financial_stability_review.html, p. 34-36.

[4] See https://www.newyorkfed.org/ibrn

[5] See https://www.banque-france.fr/en/financial-stability/international-role/network-greening-financial system

[6] See https://www.bundesbank.de/Navigation/DE/Bundesbank/Forschung/FDSZ/INEXDA/inexda.html

[7] See also the article by the French and the German governor, Francois Villeroy de Galhau and Jens Weidmann, of February 8, 2016, published in Le Monde and Süddeutsche Zeitung.

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