Olli Rehn: Europe, EMU and the banks

Keynote speech by Mr Olli Rehn, Deputy Governor of the Bank of Finland, at the Italian Banking Association, Rome, 14 May 2018.

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Accompanying slides of this speech.

Ladies and Gentlemen,

First, let me thank the Italian Banking Association for the invitation to join you today. It is a great honour to speak here, at the roots of European finance, knowing the role played by Italian banks in the development of modern banking since the Renaissance. Even more so, as I have always admired Italy's strong and hopefully continued European engagement. During my European duties I was a regular visitor to Rome for economic and political consultations, and I want to keep up this practice of European bridge-building and constructive dialogue in my capacity as a central banker in Finland.

I would like to first discuss Europe's current economic situation and then how to strengthen Economic and Monetary Union further. I will draw in my analysis from the lessons learnt during the financial and debt crisis and from my experiences in the eurozone financial fire brigade during the crisis. My focus will – very intentionally – be on what the economists call *first-best* solutions, i.e. finding optimal economic and policy solutions in the medium term, while I will refrain from assessing *second-best* constraints, i.e. the positions of Member States or the constraints set by domestic politics in the short term.

The discussion on EMU reform often becomes quite technical. While details do matter, I believe it is useful to approach the question from a broader perspective before going into institutional or financial technicalities.

Namely, the institutional transformation of the EU, or reform of the eurozone, is anything but only a 'technical' matter. It is profoundly related to Europe's relevance and influence in the world. This goes for both international security matters and for global economic governance. In the contemporary world, where the United States is distancing herself from global governance, where the United Kingdom is leaving the EU, where Russia is resorting to power politics, and where China is getting stronger and stronger, it is ever more important for Europe to act united to be stronger together and to defend multilateralism in international relations.

While we know that policy priorities in Member States differ, and common security and defence policy, as well as refugee, immigration and border-control issues, are understandably high on the EU agenda today, nevertheless eurozone reform is essential, indeed critical, for the broader endeavour to strengthen liberal democracy and international institutions, which is at the heart of Europe's peace project and part of her DNA. In other words, our efforts to reinforce EMU are part of a broader endeavour to strengthen Europe, so that it will be better in serving its citizens, by enabling their entrepreneurship, innovation, prosperity and security.

But to succeed, we must put our own house in order first. The crisis revealed serious weaknesses in the institutional structure of EMU. It revealed especially how financial stability concerns – in particular the stability of the banking system and of the government bond markets – had been neglected when EMU was created. Financial stability was the 'neglected stepchild' of Maastricht, it has been said.

The crisis finally galvanized the Union to action. There was an important, even vital, wave of institutional reforms which came about during the peak of the euro crisis. We should now seize the opportunity provided by the current favourable economic situation and complete the most

significant remaining reforms, in order to make EMU more resilient before the next recession arrives. Good times should indeed be used to reform.

So where do we stand today? The eurozone economy has now been growing for over five years. Growth is broadly based across sectors and countries. The ECB's latest forecast from March foresees growth to be 2.4% this year and 1.9% in 2019.

Figure 1. Euro area grown for 5 consecutive years (ppt slide)

The recent positive trend can be seen in this graph, showing GDP in the euro area, Italy and Germany. Euro area GDP reached its pre-crisis level in 2015. However, this includes somewhat different country-specific paths. German output reached its pre-crisis level already in 2010. While Italian output is still below its pre-crisis level, it has now returned to a growth path.

Figure 2. Euro area unemployment rates (ppt slide)

Positive developments in output and growth have also suggested encouraging trends in the labour markets. Euro area aggregate unemployment dropped to 8.5% in March 2018. The unemployment rate is trending down in almost all Member States. The German unemployment rate has dropped to a record low 3.5%, whereas unemployment remains persistently high in the countries that suffered most from the financial crisis; here in Italy it is 11.0%.

Overall, there was a strong expansion in the euro area economy in 2017. However, short-term indicators suggest that the pace of growth has cooled somewhat in early 2018.[1] Some of this could be explained by temporary factors – such as the cold winter in Europe – but recent data points to some moderation in the pace of economic growth from the high rates observed at the end of 2017. Nevertheless, the overall economic outlook for the euro area is strong, supported by favourable financial conditions, a strong labour market and steady income growth.

Yet, forecasts are always uncertain, and this one is no exception. Currently, risks to the medium-term economic outlook seem to be tilted on the downside. Externally, downside risks stem from a possible increase in protectionism, geopolitical tensions, repricing of risks in the financial markets and increased indebtedness in some emerging economies. Internal risks relate to uncertainties surrounding the implementation of reforms in the euro area, and to the public finances and banking sectors in some member states.

Monetary policy remains accommodative

Despite the recent recovery, euro area inflation has remained below its historical average for a prolonged period of time. This has been puzzling and has inspired economists to find several different explanations for the persistently low inflation.[2]

Without going into a detailed list of these explanations, it seems that the financial and debt crisis that the euro area faced was exceptionally deep and persistent, which has had an impact on inflation expectations. However, the latest estimates of excess capacities point to a closing output gap. This, together with the ECB's accommodative monetary policy, is expected to lead to a gradual pick-up in inflation rates. The ECB's recent forecast expects euro area annual inflation to reach 1.7% on average in 2020.

The ECB Governing Council reiterated on 26 April that an ample degree of monetary stimulus remains necessary for underlying inflation pressures to continue to build up and support headline inflation developments over the medium term. The Governing Council stressed the importance of patience, persistence and prudence in its monetary policy-making.

But monetary policy alone cannot provide sustained and balanced growth in Europe. Therefore, it is important that economic reforms and strengthening the eurozone are kept on the Member

States' policy agenda. Next, I will address some of the key issues of reform.

Completing the Banking Union

Completing the Banking Union is crucial for the stability of the European banking system, and hence a necessary priority of eurozone reform.

Significant progress has been made on the Banking Union since 2012. The Single Supervisory Mechanism and the Single Resolution Mechanism have been established. At the same time, the financial stability of the euro area has improved. The capital positions of euro area banks have strengthened, as can be seen from Figure 3.

Figure 3: Euro area banks' capital positions are strengthening (ppt slide)

However, the work to strengthen the euro area financial system and to increase stability must continue. It is important to strive further to reduce the probability of shocks that could jeopardizestability of the euro area banking system.

In this respect, priority should be given to strengthening the resolution and deposit guarantee schemes.

Let me say first some words on the setting up of a fiscal backstop to **the Single Resolution Fund**, the privately financed capitalization tool of the Single Resolution Mechanism (SRM).

Such a fiscal backstop is important in order to give solid credibility to the commitment of the SRM to resolve, wind up or reorganize failing banks, quickly and effectively. As ECB President Mario Draghi said in Firenze on Friday, public risk-sharing through backstops helps reduce risks across the system by containing market panics when crisis hits. The backstop would be a reserve instrument, activated only if the Single Resolution Fund becomes temporarily short of the resources required for its tasks, even after the owners and eligible creditors of failing banks have borne the losses allocated to them.

Financially, the backstop could operate as a credit line in the reformed European Stability Mechanism. It should be fiscally neutral, so that, over time, the Single Resolution Fund and ultimately the banking industry itself would replenish any funds drawn from it.

Let me turn to the issue of **deposit guarantee scheme,** the ultimate objective of which is to prevent bank runs. A bank run is usually caused by lack of confidence in a single bank or in a banking system. The stronger and more credible the deposit guarantee scheme is, the less likely it is that it will have to be used.

The sustainability of **the suggested new European deposit guarantee scheme** has been assessed in a recent study published by the ECB.[3] It states that even in the event of a major banking crisis, deposits could be secured by a common deposit guarantee fund. The fund would be financed by the banking sector. An interesting result of the study is that very little cross-subsidization would take place between countries when the funds are collected from banks on the 'polluter pays' principle, i.e. according to their risks.

A common European deposit insurance scheme would significantly increase the stability of the euro area banking system compared with the current situation in which national funds are responsible for the deposit guarantee. The goal should be that confidence in the secured bank deposits is equally strong throughout the euro area.

Reducing risks in the euro area banking system

The implementation of a common European deposit insurance scheme can be enhanced by

reducing risks in the euro area banking system. Overall in the euro area, significant progress has already been made, as the level of **non-performing legacy assets** has decreased. This development is clearly visible in Figure 4.

Figure 4: NPLs are decreasing in the euro area[4] (ppt slide)

As we know, the position of countries varies a lot concerning the share of non-performing loans (NPLs) of the total stock of loans across the euro area, as does the speed of reduction in their amount (see Figure 5). Spain did utilize well and effectively its ESM-funded financial-sector repair programme, which started in summer 2012, and has moved further towards solving the problem by reducing the share of NPLs to around 5% by the end of last year, i.e. close to the euro area average. Italy took action later and has managed to reduce the amount of NPLs in its banks by about 30% in two years, and the share of NPLs in Italy in 2016–17 came down from 16% to around 11%. Hence, while progress has been made, there is still plenty of work to be done to maintain the positive trend in NPL reduction.

Figure 5: The reduction of non-performing loans by country (ppt slide)

In any case, to mitigate risks in the banking system, it is important to reduce the amount of NPLs further. The position of the Bank of Finland is that the resolving of legacy problems should be separated from the management of future non-performing loans. The SSM has already published a proposal on provisioning methodologies for new NPLs that will increase banks' loan loss provisions and resilience.

To ensure the most effective reduction of NPLs, legacy problems should be handled with a combination of bail-in and recapitalization by national funds, in line with the state aid guidelines (2013) set out by the Commission. Transitional provisions should provide an opportunity for this by facilitating the write-down of non-performing exposures to a level that enables market-based solutions, e.g. the selling of NPLs to investors. In due course the transitional provisions should of course be abolished.

Market-based solutions are obviously the primary alternatives for resolving non-performing loans. However, a single solution alone is hardly the answer. History has taught us that the most viable solutions are usually a combination of several alternatives.

Going forward, and thinking particularly about the stability and resilience of the European banking system, it is also important that banks' exposures to their home countries' sovereign bonds be reduced. One solution is that banks could be required to have more capital if they want to hold high amounts of a single country's sovereign bonds.[5] This concentration charge would give banks an incentive to diversify their sovereign bond holdings. It would also support market-based risk-sharing in the euro area.

Why would this be important for the future of the eurozone? Simply because breaking the undesirable links between national banking sectors and their sovereigns is one of the fundamental reasons for creating Banking Union. Let's keep this overall objective firmly in sight and mind when pursuing reform.

ESM reinforced

Secondly, Europe's financial firewall, the European Stability Mechanism, should be further developed by reinforcing its capacity to take decisions and extending its toolbox with a more workable and effective precautionary credit instrument.

In the event that the euro area faces excessive market turbulence, the ESM should be able to take rapid, effective decisions to help stabilize the situation. Decisions on conditional loans or credit lines could in an emergency situation be taken by a reinforced majority of e.g. 85%; recall

that the IMF board, while striving for consensus, can take decisions by a simple majority. Decisions on the capital base would continue to be taken by unanimity, underlining the Parliament's budgetary powers.

For a precautionary credit instrument, a pertinent benchmark is provided by the IMF's Flexible Credit Line (FCL), which was successfully used during the crisis by three countries: Colombia, Mexico and Poland, as a crisis-prevention instrument against market turbulence. None of the three countries had to draw on these lines, as the FCL provided an effective backstop for these countries and strengthened market confidence during the time of elevated risks.

So, in my view the primary reform of the ESM now needed is to enhance its concrete functionality and capacity to act in cases of market turbulence. But I duly recognize there are other proposals on the table as well. One is to change the name of the ESM to European Monetary Fund, EMF. Would this be justified? To my mind the nameplate is less important than the substantive improvements in the functioning of the ESM. Besides, the ESM has become a positive, solid brand, based on the high integrity and professional quality of the institution and its staff, under the competent leadership of its Managing Director, Klaus Regling.

Another reform proposal relates to the institutional dimension. To increase accountability, the European Commission has proposed to transfer the ESM into the EU Treaty and put it under parliamentary control of the European Parliament, in a rather similar way as the ECB is – mostly focusing on the full right of demanding and receiving information. On the other hand, the Commission proposal would maintain the key policy decisions and executive functions in the hands of the Board of Governors. This includes the decisions to approve of conditional financial programmes and the appointment of the Managing Director. Hence the Commission proposal is actually less of a great federalist leap forward than some fear and others wish.

In principle, there are two alternative ways of making progress in European cooperation, either by the well-tested Community Method or by the intergovernmental method, which some years ago was described as the Union Method. For the EU to continue making legitimate progress in integration, in my view it is necessary to take good care of the Community method, since it is able both to provide the effective capacity to act and the legitimacy to take decisions. It is based on the Commission's right of initiative, its independence and professionalism, the qualified majority rule in the Council and co-determination by the European Parliament. It enables the Union to take decisions and keeps all Member States – including the small states – on board.

Revisions of fiscal rules: the expenditure rule

Let me turn to my third and final subject: the revision of fiscal rules, in particular by introducing the expenditure rule into the EU fiscal rules.

In the future, the economic and Monetary Union can work smoothly only if the public finances of all member countries are credibly on a sustainable footing. A combination of fiscal policy rules and market discipline related to government borrowing is necessary to ensure this. Fiscal rules should be sufficiently simple to ensure that, in normal circumstances, we can be certain in advance that they will be adhered to when budgets are prepared.

The expenditure rule can usefully be defined as a medium-term ceiling for the real growth of general government expenditure, set in relation to the estimated future economic growth and taking into account the stock of public debt. In my view, such a rule, focusing on mid-term debt sustainability and solidified by concrete multi-annual ceilings on budget lines, would probably serve better as an operational fiscal policy guide than the current rule that is based on the structural fiscal balances.

Our present system of fiscal rules and fiscal policy coordination is a result of the reforms agreed in 2011, the so-called six-pack. This strengthened the euro level governance of fiscal policy in a

significant way. In the past five years, the overall budget deficits of euro area countries have diminished substantially. Last year, **the aggregate General Government Deficit** was less than 1% of euro area GDP. Indebtedness (defined as the ratio of government debt to GDP) has started to decline. Of course, the situation varies across countries, especially regarding the level of accumulated debt.

Figure 6: Fiscal deficit in the euro area 2000-2018 (ppt slide)

Despite the positive developments of recent years, I think the present system of fiscal rules and policy coordination in the euro area is far from perfect. My concerns are that 1) the rules have become very complicated; 2) the system has not been as effective as hoped, especially in the past; and 3) it is more procyclical than necessary.

These problems with the current system of rules are interrelated:

The complexity of the rules results largely from efforts to make them less procyclical, by applying such concepts as structural deficits instead of drawing the rules in terms of the actual, nominal deficits. The measurement of structural deficits is notoriously difficult, however, which adds an element of discretion in the application of such rules – not making the results politically easier to accept. At the same time, the inevitable procyclicality of the deficit rules makes them hard to implement (especially in recessions) and therefore less credible in the first place.

Reliance on rules would be less of a problem if ‘market discipline’ could be trusted to keep the finances of the Member States on the narrow path of sustainability. By market discipline we mean the constraints that market perceptions of a country’s creditworthiness puts on its borrowing.

Market discipline is a necessary part of an economic system where all actors are ultimately responsible for their decisions – even when the decisions go wrong. However, this does not mean that market discipline as such would operate in a smooth, always effective manner from the societal or economic point of view. As evidence, we can recall that market discipline did not work well in the years leading up to the crisis (when the markets were disregarding the accumulation of risks), nor did it work well when the crisis was at its most intense (when the markets reacted in a disruptive way).

This experience is fully in accordance with the Delors report of 1989. This report, which served as a blueprint for Monetary Union, noted that market forces can exert a disciplinary influence on the fiscal policies of the member states, but added:

‘…market perceptions do not necessarily provide strong and compelling signals and (that) access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive.’

Because of the often on/off nature of market behaviour, the euro area needs effective and credible ex ante rules for fiscal policy that will prevent countries from hitting the financing constraints on the markets.

Expenditure rules provide governments a less procyclical way to commit to sustainable public finances than deficit rules do; by being less procyclical, they are also easier to stick to, and therefore more credible. A number of countries, such as the Netherlands, Sweden and Finland, have used expenditure rules as the major building block of their medium term fiscal frameworks for a long time over the past decades, with relative success. The expenditure rule thus supports responsible fiscal policy, and increase national ownership of sustainable public finances. It could

well be applied across the EU.

The need for further economic reforms

It is not only our common currency area which is in need of reform. The biggest bulk of beneficial economic reforms are in the responsibility of national policy-makers. These reforms would be beneficial for the welfare of euro area citizens by promoting long-term income and employment growth, resilience of the economies to adverse shocks, and social fairness and inclusiveness. By facilitating adjustments to regional shocks they would ensure the smooth functioning of the euro area and the efficient transmission of monetary policy. Therefore, better economic structures have importance also from the perspective of monetary policy.

What is then meant by ‘better economic structures’? This phrase covers a wide range of policy agendas, but these are commonly understood as flexible product and labour markets. In addition, well-functioning and trustworthy public institutions lead to better economic outcomes.

Figure 7. Ease of doing business and GDP per capita (ppt slide)

Due to their many faces, measuring the quality of economic structures is not straightforward. One common measure is the World Bank's ‘Doing Business’ indicator, which compares the ease of doing business across countries. From the graph we see correlation between the indicator and GDP per capita. There is also some evidence that those euro area countries that had better functioning institutions recovered faster from the latest financial crisis.[6] The indicator also reveals large differences in the ease of doing business across euro area Member States. Whereas the best performers are close to the global top performers,[7] the weakest Member States are hardly in the global top 50. Anyway, every euro area Member State should be active in enhancing their economies.

An example of successful reforms are the pension reforms that many EU Member States implemented over the last decades.[8] These reforms have enhanced fiscal sustainability, helped to maintain adequate pension income and also contributed to increased labour participation rates.

During the recent crisis many countries reformed their economies, and these reforms have contributed to the current upswing, but will also bear fruit in future. For example, Italian labour market reforms have brought your labour market institutions more closely in line with international benchmarks, and there are already some tentative signs of its positive impacts.[9]

Which reforms should each country then take, for their own sake? The most rewarding reforms depend on each countries' current structure and need to be tailor-made for local circumstances. However, the OECD has found that implementing reforms in different areas seem to provide significant synergies.[10] For example, labour market reforms will facilitate the necessary reallocation of workers arising from product market reforms.

The European Commission's annual Country-Specific Recommendations provide a thorough and tailored guideline for the serious reform agenda. It has, indeed, been disappointing to see that the momentum for implementing these policy recommendations has weakened in the euro area. The Commission has concluded that the overwhelming majority – more than 90% – of last year's reform recommendations have been followed by only ‘some’ or ‘limited’ progress in implementation, while just one (of almost 80) of them has been substantially implemented.[11]

Why is this worrying? Because the good times of solid growth and expansionary monetary policy are not going to last forever. Monetary policy cannot be “the only game in town”. The better times should be used for reforms that may be difficult in the short term but carry benefits in the medium-to-long term. And today’s reduced funding costs for sovereigns should be used to

enhance debt sustainability, especially in countries where solid debt sustainability is not self-evident due to the high level of public debt. This would help creating the badly needed fiscal space in the next recession, both for individual member states and for the eurozone in aggregate.

Conclusions

In conclusion, there is a strong case to move on with the ever-changing evolutionary Union. The dichotomy of 'federation or death' has been put forward too often, and frequently for propaganda reasons. But let me reveal you a secret: it is fake news.

Namely, the euro area will not survive by simply becoming a federation or transfer union – but neither will it break up just because of not becoming one. Life is seldom black-and-white.

Instead, there is an evolutionary third way – what we need is both a sense of direction and a sense of realism. The essential guiding principle in reforming euro area economic governance should be that steps towards increased solidarity through co-insurance and risk sharing are combined with increased responsibility and economic sustainability. Solidarity can only be built on solidity, for the sake of both economic sustainability and political legitimacy.

While the institutional reform of Economic and Monetary Union is important, Europe needs to work towards sustainable growth and job creation on all fronts. Putting the real economy and reforms truly centre-stage means that we should continue to work for a Europe that opens up our citizens' opportunities to innovate and build new businesses, and thus create jobs, for a Europe that seeks to promote sustainable growth through free-trade agreements, despite headwinds; for a Europe where citizens and businesses can benefit from a genuine single market; and for a Europe that guarantees civil rights and social justice in the digital age.

These are the concrete, functional goals for sustainable growth and job creation that really matter to our citizens in Europe, which should always be our yardstick. They should be supported by rock-solid financial stability by completing the Banking Union. This is a policy agenda that can help making Europe relevant and moving on.

Thank you very much for your attention!

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[1] The preliminary flash estimate on the GDP growth rate for the first quarter of 2018 was 0.4%, while in the last quarter of 2017 the growth rate was 0.7% from the previous quarter.

[2] For a thorough review of the discussion see Constâncio, V. (2017) 'Understanding and overcoming low inflation', Remarks at the Conference on 'Understanding inflation: lessons from the past, lessons for the future?', Frankfurt am Main, 21 and 22 September 2017; and Yellen, J. (2017) 'Inflation, Uncertainty, and Monetary Policy', Remarks at the 'Prospects for Growth: Reassessing the Fundamentals' 59th Annual Meeting of the National Association for Business Economics, 26 September 2017; see also Kortela, Oinonen & Vilmi (2018) 'Reports of the Phillips curve's death are greatly exaggerated', Bank of Finland Bulletin 1/2018.

[3] Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation? ECB Occasional Paper Series No 208 / April 2018 www.ecb.europa.eu/pub/pdf/scpops/ecb.op208.en.pdf?557c7f15bddfac62f842fd08920b1e6e.

[4] The NPL ratio in Italy was 11.1% in Q4 2017.

[5] This option is suggested by a group of French-German economists: Reconciling risk sharing with market discipline: A constructive approach to euro area reform, January 2018 cepr.org/sites/default/files/policy_insights/PolicyInsight91.pdf

[6] Draghi (2017), 'Structural reforms in the euro area', Introductory remarks at the ECB conference 'Structural reforms in the euro area', Frankfurt am Main, 18 October 2017; and Bank of Finland (2018), 'Euro countries recovered from crisis at different paces', Bank of Finland Bulletin 1/2018.

[7] The top 3 performers are New Zealand, Singapore and Denmark.

[8] For further information, see Carone, G. et al. (2016). Pension Reforms in the EU since the Early 2000's: Achievements and Challenges Ahead. European Commission Discussion Paper 042, December 2016.

[9] For a detailed analysis see Pinelli, D. (2017). The Recent Reform of the Labour Market in Italy: A Review. European Commission, Discussion Paper 072, December 2017.

[10] OECD (2016), Economic Policy Reforms 2016: Going for Growth Interim Report, OECD Publishing, Paris.

[11] For a detailed analysis see ECB (2018). 'The European Commission's 2018 assessment of macroeconomic imbalances and progress on reforms'. ECB Economic Bulletin, Issue 2/2018, March 2018, Box 8.