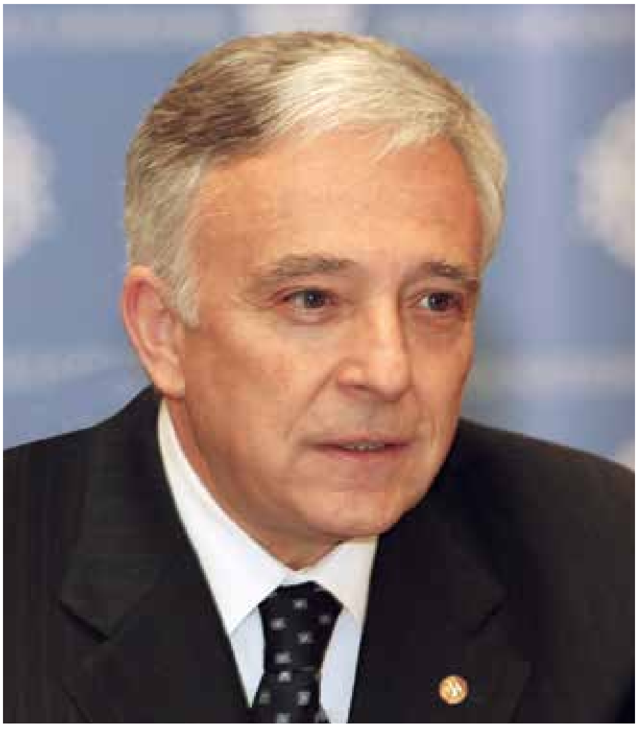
Q&A

Mugur Isărescu

Governor,
National Bank of Romania

Financial integration in Europe: challenges and prospects



WHAT IS YOUR OVERALL ASSESSMENT OF THE PROGRESS MADE IN FINANCIAL INTEGRATION IN EUROPE? HOW TO EXPLAIN THE DEEPENING OF THE FRAGMENTATION OF EU BANKING MARKETS ALONG NATIONAL LINES SINCE THE CRISIS? WHAT ARE THE CONSEQUENCES?

Financial integration is an essential driver in enhancing competitiveness and redirecting available capital across Europe. Moreover, it fosters a smooth and balanced monetary policy transmission throughout the euro area, being key for completing the EU Single Market.

Space for improvement certainly exists and countries like Romania could significantly benefit from deeper financial integration, especially those having an underdeveloped capital market.

The fragmentation of EU banking markets along national borders in the wake of the crisis is the consequence of risk mispricing during the boom: fragmentation has increased simply because market participants were not aware of or ignored the fact that the institutional architecture of the EMU was incomplete. The lacking institutional pieces could no longer be underplayed after the crisis. Completing the EMU in order to facilitate risk-sharing is the way forward to address financial fragmentation.

As regards its consequences, they concern mainly the effectiveness of the transmission mechanism of the ECB's monetary policy. Financial fragmentation hampers the functioning of the standard interest rate channel. While a reduction in financial fragmentation has been achieved as a result of broad-based non-standard policy measures taken by the ECB, there are limits to unorthodox policies and monetary policy will eventually need to normalise. Having in place an institutional set-up that relies on risk-sharing too is a prerequisite for a well-functioning EMU and an effective monetary policy.

WHAT WOULD BE THE APPROPRIATE LEVEL OF INTEGRATION OF THE BANKING SECTOR IN THE EU AND THE EXPECTED BENEFITS? IS FURTHER CROSS-BORDER CONSOLIDATION POSSIBLE IN THE EU? WHAT SHOULD BE THE POLICY PRIORITIES OF THE NEXT EU LEGISLATURE IN THIS AREA?

The appropriate level of banking sector integration is difficult to assess, but what is obvious, in my opinion, is that pre-crisis levels may not be proper benchmarks as the negative spillovers propagated at a fast pace. Having said this, a collective deposit insurance scheme and a much stronger Resolution Fund are a must for the Banking Union, paving the way for a sustainable financial integration. Additionally, the introduction of instruments that can help Member States to deal with asymmetric shocks is also needed for improving risk-sharing among them.

The reforms of the regulation and supervision of the financial industry have taken us into the right direction, making our banks and the overall system safer. The European banking sector has reduced non-performing loans through balance sheet clean-up measures and it is now better capitalised. But much attention needs to be paid to systemic risks in non-bank financial markets.

However, one effect of more integrated financial markets may be the decline of financial intermediation in some non-euro area EU countries, Romania and Hungary in particular, as international companies opt for credit outsourcing (where it may be cheaper).

Speaking about non-euro catching-up countries, no matter how much one wishes to put single currency adoption onto a fast track, success hinges on having achieved a critical mass of real and structural convergence. The lessons of the euro area crisis remind us this reality. The more robust the euro area turns as a result of institutional and policy reforms, the better for the current and prospective members.

Fiscal discipline is straightforward for a macroeconomist. The pitfalls of a lack of fiscal discipline are obvious: a near-sighted fiscal policy translates into persistent deficits, rising debt levels, output volatility and, ultimately, a loss in policy credibility. In general, adequate macroeconomic and macroprudential policies are needed to control external imbalances, for excessive private indebtedness is no less dangerous.

In Europe, however, there may be more to the desirability of fiscal discipline than the macroeconomic argument. It may very well have a political dimension: a commitment to fiscal discipline is needed for further integration. It is difficult to imagine a scenario in which the institutional risk-sharing set-up required for strengthening the banking union and breaking up the sovereign-banking system doom loop comes into existence in the absence of a firm commitment to fiscal discipline. Among the EU Member States, as between the participants on the insurance market, one cannot expect to reach an agreement involving risk-sharing if its winners and losers are known beforehand and presumed to stay as such for ever.

Beyond any concrete policy measures, I trust that the next EU legislature will find the right balance to address key institutional and policy related weaknesses.

WHAT SHOULD BE THE MAIN PRIORITIES OF THE UPCOMING COMMISSION FOR HARNESSING DIGITALIZATION DEVELOPMENTS IN THE FINANCIAL SECTOR? WHAT ROLE CAN THE EU PUBLIC AUTHORITIES PLAY IN THIS AREA?

Without any doubt, digitalization plays a key role in enhancing productivity and competitiveness, contributing significantly to economic growth. This is also valid for the financial sector, where digitalization is needed even more than in other sectors, as it facilitates business transactions economy-wide. The impact of digitalization development on the financial system may be considerable, as technological innovation has the potential to reshape the current structure of this system. The EU authorities must stand ready to address these challenges.

The outlook on payment and settlement systems hinges on keener competition, tighter regulations and stronger customer preference for digital experiences. The sustainable development of digitalization and technology-driven innovation in financial services (FinTech) requires an adequate competitive environment, which can be ensured by introducing a set of EU-wide applicable standards and rules. Moreover, establishing a clear and comprehensive regulatory framework governing the new technological progress in the financial field is a key prerequisite for the harmonized integration of FinTech products in Europe. The new set of rules should address technological and operational requirements, from the perspective of both the business environment and the supervisory authorities, with a view to containing the materialization of risks to financial stability. Therefore, the main priorities that EU authorities should focus on in order to harness digitalization development in the financial sector are related to: establishing a legal framework for a regulated environment; enhancing a prudential supervisory framework; promoting specific technological education along with the exchange of information security data; enhancing the security and integrity of the European financial system.

IS A STRONGER LONG-TERM INVESTMENT CAPACITY NEEDED IN THE EU AND WHAT WOULD IT INVOLVE? WHO CAN PLAY THIS ROLE IN THE EU AND WHAT REGULATORY, SUPERVISORY AND ECONOMIC FRAMEWORK IS NEEDED?

The prospect of a hard Brexit is distressing, as it entails high uncertainty, shaking the grounds of planned investment, future trade and free movement of labour. It occurs at a time of a relative economic slowdown all over Europe, an erosion of multilateralism and broadening trade conflicts.

Poor investment prospects are worrisome given that half of EU countries continue to post below pre-crisis investment levels and, on aggregate, EU capital formation barely stands on a par with that witnessed prior to the outbreak of the crisis. Many empirical studies have placed uncertainty among the main drivers of investment dynamics, and this is not surprising. Investment requires irreversible expenses, so a “wait-and-see” attitude becomes more appealing. Moreover, risk aversion most often prompts businesspeople to boost precautionary saving.

To deliver clear and credible messages that mitigate the concerns of businesses and consumers alike is a challenge that policymakers need to live up to, and they certainly know it. It is high time to strike a deal on the Multiannual Financial Framework so that the great challenges the Union is facing (protection of borders, cyber fare, climate change, conflicts in near and more remote regions) are solved in a way compatible with preserving the EU’s cohesion. Having a euro area budget does make sense, but it should, arguably, stand on its own feet and not hollow out the EU budget.

As a central banker, I have to point out that monetary policy plays an essential role in ensuring an economic climate conducive to long-term investment and subsequent sustainable growth. The economic recovery of recent years has heavily hinged on non-standard measures of major central banks and very low interest rates.

There are still large public and private debts, which prove especially burdensome in the euro area – and which compound the mission of monetary policy normalisation, of unwinding the ECB’s non-standard measures. Fortunately, some emerging EU economies (including Romania) are in a much better position in this respect.

Irrespective of the pace of monetary policy normalisation in Europe, keeping internal and external imbalances in check, including through the implementation of structural reforms, is essential to achieve lasting economic growth. The future might look uncertain, but we can surely try to be better prepared for it. ●