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Europe can no longer afford a muddle through approach to its financial system

Europe's single currency continues to surprise its sceptics, showing resilience in crises and delivering a safe store of value to its citizens. It is fair to say, however, that the euro has fallen short of its potential, and not least due to its fragmented financial system. Completing Banking Union and building out Capital Markets Union (CMU) are commonly agreed goals, but paths have divided on how to achieve this, at no small cost to jobs and growth, and overburdening the ECB in the process.

The Covid19 crisis has dramatically compressed the timeframe to deliver, not only due to the unprecedented growth shock but also by accentuating several pre-existing trends. In a world where protectionism and the willingness to use finance as a diplomatic weapon is only increasing, the absence of a strong financial system threatens both Europe's ability to recover and its economic sovereignty.

European banks entered the current crisis well capitalised and this, combined with the swift action by governments and the ECB, has helped protect the supply side of the economy from the initial liquidity shock, and not least at a time when foreign banks have tended to pull back.

Ensuring sufficient European bank capital to finance recovery will require that the finalisation of Basel III does not result in an excessive capital burden and that banks can continue to access a diverse pool of private investors. Near-term, visibility on temporary measures including dividends would help ease investor concerns, but the key metric ultimately is profitability.

The prospect of losses due to Covid19 is something that banks share globally, but Europe's fragmented and cumbersome approach, be it tackling NPLs, bank resolution, the regulatory framework or future integration adds significant pressure. The detrimental effects were already all too visible pre-crisis, holding back the transformation of financial system even as Brexit loomed.

Consolidation of the European banking industry is central to securing economies of scale and freeing up resources for the much-needed digital transformation. Early July saw the ECB launch a public consultation on its supervisory approach to consolidation and this marks a positive step, but far more work is required to secure the single jurisdiction key to any Banking Union.

Equally critical is delivering CMU. It is evident from the current crisis that non-financial corporations need more equity capital. Excessive reliance on debt not only leaves non-financial corporates more vulnerable to refinancing risks but may arguably also be holding back more productive investments, thus weighing on trend growth. Accessing a diverse pool of equity financing requires deep capital markets and consideration should also be given to the securitisation framework, the coordination of supervision, and the relative tax and regulatory treatment of debt and equity.

A single safe asset is often seen as a bellwether to finalising Banking Union and delivering CMU. The landmark Council agreement on Next Generation EU, will pending parliamentary approval, allow the Commission to raise €750bn of debt on capital markets and marks important progress; but this is not the genuine single safe asset that the euro area needs and overcoming the political hurdles will take time. Even absent a single safe asset, there is room for considerable progress on CMU and the recent conclusions of High-Level Forum offered a welcome tangible roadmap.

The time to act is now. The ECB has already taken its rates to exceptionally low levels and the existence of a reversal rate, where the effects of further monetary easing turn contractionary, is well accepted. While its level is yet unknown in practice, finding out could trigger a new major crisis that Europe cannot afford. It's no wonder that the ECB continuously calls for greater financial integration and a stronger international role for the euro.

It's no exaggeration to say that the euro's future today depends on its financial system; absent a strong and unified system, Europe will struggle to finance recovery and not least one that prioritises its goals of a greener and fairer society. The option to continue to muddle through and rely excessively on foreign banks, third-country financial centres and the dollar is simply no longer viable. ●