



How to improve Economic and Monetary Union

Paschal Donohoe - Minister of Department of Finance, Ireland & President, Eurogroup

Irene Tinagli - Chair & MEP, Committee on Economic and Monetary Affairs, European Parliament

Jacques de Larosière - Honorary Chairman, EUROFI

Vitorio Grilli - Chairman of the Corporate and Investment Bank EMEA, J.P. Morgan

David Wright - President, EUROFI

David Wright (Chair), President, Eurofi

David Wright (Chair) highlighted the importance of the panel and introduced the panellists. The topic is how to improve economic and monetary union given increasing economic and financial fragmentation. David Wright (Chair) invited Paschal Donohoe to open with some remarks.

Paschal Donohoe, President, Eurogroup & Minister for Finance, Ireland

Paschal Donohoe noted the return of naked military aggression to Europe. The rule of international law has been usurped by unprovoked military actions that tragically will bring enormous human suffering. That poses the question of the value and worth of these discussions, given the scale of the events unfolding. However, it is because of what can be seen to be happening elsewhere that there is a need to be reminded of the huge value of unity, strength and the depth of what all have built across the European Union.

Within 40 years of war on the continent, all moved to the point where they were engaging and negotiating with each other on, for example, the intricacies of a common market. Europe has moved on to an even more united front, and shortly there will be the imposition of the harshest package of sanctions ever implemented by the European Union. The European Union will stand absolutely united in protecting its common values and freedoms, and its rules which have brought such massive economic and social benefits to all Europeans.

Paschal Donohoe wanted to make some remarks on the work and priorities of Eurogroup, the coordination

of European economic policy and the immediate outlook for progress on key priorities.

An ambitious work plan on Banking Union (BU) is one of Paschal Donohoe's priorities as President of the Eurogroup. It is critical for the credibility of the financial sector and the EU's economic scale on the global stage, which needs to be reflected in a banking sector that can serve EU citizens, small and medium-sized enterprises (SME), corporates and can deliver on the ambitious and vital needs of the twin transitions to a more digital and a lower-carbon future.

The work plan aims to be a political framework to deliver tangible progress, and to serve the goals of depositor protection, robust crisis management, and a stable, resilient and competitive banking sector which is capable of facilitating broader economic growth.

Along with the promotion of retail investment, and an open-end strategy Capital Markets Union (CMU), a Banking Union is critical to the future of the EU's monetary union as a shock absorber to support economic recovery and to drive the twin transition.

Every finance minister has different priorities for the Banking Union project. At the same time, at every European Council that Paschal Donohoe attends he receives the mandate to make progress on the same project. Having talked to all of the finance ministers over recent weeks, there is clearly further willingness to devote time and energy to agreement on this project.

At the March Eurogroup meeting there will be a further discussion on a potential work plan. This work plan will cover four work streams: commitment to a common protection for depositors, how to promote

diversification of bank sovereign exposures, improving the management of failing banks and how to create the conditions for a single market of banking services.

The concept of sequencing is as important as the content. The hope is to deliver a phased and gradual approach that is more capable of developing trust and creating an environment in which there is delivery across all work streams.

At this stage Paschal Donohoe envisages three phases. There are the immediate steps based on Commission proposals to deliver tangible results. Then there are medium steps to introduce gradually, and in parallel to all four areas, the core concepts of a more complete Banking Union. Then there is a longer-term view where the steps taken are reviewed to ensure that what is wanted has been delivered. At that stage, if it is agreed that they are needed, additional measures can be worked on.

The aim of phasing is to allow for a build up of trust, which is critical, and to make sure that in building this trust there is delivery across all work streams. Accompanying this approach, there could be checkpoints along the way to make sure there is parallel delivery. This is a delicate balancing act. It is complex and highly sensitive politically. Paschal Donohoe will continue to rely on all finance ministers, particularly after the efforts of the last year on this project, to assist in the development of proposals that bring consensus closer, with a view to delivering a political framework for progress in the coming months.

Regarding other issues on economic policy, there has thus far been a very strong and very rapid recovery across the euro area. There was growth of 5.3% last year and unemployment at a record low of 7%. Economic prospects for 2022 remain robust, but there are now two key areas of concern to all finance ministers: the familiar challenges of monitoring inflation across the euro area and the most recent and most grave developments taking place in Ukraine, which will be front and centre of ministers' minds when they meet in the morning.

As this is addressed, policy will need to remain agile. Agility has been a hallmark of economic policy during the pandemic, as it has led to coordination and consensus. This in turn has created an environment in which budgetary and monetary policy are able to work together. The Eurogroup has played a critical role in this.

Paschal Donohoe noted that the supportive monetary policy decisions of the European Central Bank (ECB) were coupled with swift, decisive and coordinated actions by ministers. Eurogroup will continue to have regular discussions and make decisions on these matters. It is in that context that the future of economic governance will be debated over the coming months, and the Eurogroup will play an active role in this process. Looking to the future, a policy mix will be pursued which supports the recovery, promotes investment and safeguards the sustainability of debt.

These objectives are mutually compatible, but the balance must be right. The role that the private sector will play in driving and facilitating change must be

recognised, especially in the capital needs to meet the investment needs of the great transitions. This is why work on Banking Union, on economic governance and the broader economic policies are so intertwined and co-dependent. It is this integration and dependency which will continue to be used as a source of mutual benefit as new and grave challenges on the European continent are confronted.

David Wright

David Wright (Chair) invited Irene Tinagli to comment on the key issues for improving the monetary union given the current context.

Irene Tinagli, Chair, European Parliament Committee on Economic and Monetary Affairs (ECON)

Irene Tinagli thanked Paschal Donohoe for his extraordinary efforts with the Eurogroup in trying to get it unblocked and to make progress. The different perspectives among the member states can be seen in the Parliament as well as among different political groups and different delegations, so Irene Tinagli appreciated the complexity of the issue. However, by now, and especially with the past couple of years, all should be aware of what is at stake and the urgency of moving forward.

The difficulty is finding a strategy for moving forward. The question is what the priorities are, bearing in mind that some things are interlinked and need to be addressed together. If only one thing is done at a time the EU may end up stuck in the pros and cons of that single issue and not move forward. Therefore, it is important to have a more holistic, comprehensive and pragmatic approach, bearing in mind the final objective.

The Banking Union will also need progress with the CMU. There is one aspect in particular that can be beneficial for both, which is to create a real, common, safe asset. This instrument would provide a stabiliser and the possibility for a high-level shock absorption capacity. It would also help to ensure an effective transmission of monetary policy decisions. This was seen with the bonds issued in the past year and a half for the Recovery and Resilience Facility (RRF). The high quality of the bonds has been seen along with how attractive they are to investors.

The second issue, building up on a European safe asset, is the issue of fiscal capacity. This would be crucial for complementing the action of the European Central Bank and guarantee, not only in the short and medium term but also in the long term, coordination between monetary and fiscal policy, the importance of which has been demonstrated in the past couple of years. Being able to put this policy mix in place and have these diverse instruments, both monetary and fiscal, has proven how many positive effects there can be. At one of the last ECON committee hearings, Paschal Donohoe answered a question from an MEP, which was critical about the deployment of policy instruments, by highlighting the difference between the response to this crisis and how long it took to get over the past great recessions. Having this policy mix is important, so it is important to think about how to guarantee this capacity and policy mix for the future.

David Wright

David Wright (Chair) asked Vittorio Grilli to comment.

Vittorio Grilli, Chairman, Corporate & Investment Bank, EMEA, JP Morgan

Vittorio Grilli was encouraged by the detailed plan described by Paschal Donohoe and its ambition. BU is crucial and it is a cornerstone for much of the political and economic ambition of Europe, not just as an enabler of the digital and lower-carbon transitions, but more generally for the competitiveness of Europe as a whole and of its own banking sector.

The financial and banking sectors are in a deep transition globally. In order to face those transitions from a position of strength the BU seems to be very important. Banks are facing increasing competition from nonbanks, such as payment companies and fintechs and exchanges and BigTech, which are outside the banking regulatory system.

There is also a technological transition that will impact the financial sector. There are the cryptocurrency and digital coin issues which are all very complex challenges that will require further steps in the direction of a true BU.

Vittorio Grilli stated that with the challenges from the perspective of the financial and banking sector it is a pivotal point on monetary union and also monetary policy. There has been extreme success in dealing with the last two years and a major changing pace of coordination between fiscal and monetary policy. That has been the essence of the resilience of the European economy, as well as the global economy because other areas of the world have effectively done the same.

With the Ukraine crisis there is more thinking about when the right time is and to what extent the monetary stance should be changed. Much debate in financial markets is on exactly how this reversal of action will take place. As the initial measures were unprecedented this reversal is also unprecedented, and therefore will represent many challenges. However, the current situation is thanks to this policy and the strength of the economy, the financial market and the banking sector. Banks are now very well capitalised and very well supervised. There are many tools at the disposal of regulators. This reversal of policy will take place in a banking sector which is strong and more able to face these challenges.

Vittorio Grilli noted that there are issues about the speed and sequencing of the unrolling of the asset purchases programme and the change in interest rate position, both of which will impact the real economy. For the financial crisis of 2010/2011, initially the weak points and the challenges were within the banking sector. Now the banking sector is probably the strongest asset the real economy can rely on; the concern is how the real economy will stand this reversal of policy, compounded with what has been seen on the market which, unfortunately, Ukraine will compound, namely increasing energy prices. There are clear bottlenecks in the supply chains. These are important challenges for the real economy. The

question is how that will play with the change in stance in both monetary and fiscal policy.

That is the challenge. The real economy is going to face real challenges, and the question is if this change or the removal of this extensive support can be done without altering the good state of health of the economy, both for the real economy and the financial sector. However, the starting position is one of strength for the banking and financial sector. Additionally, changes in interest rates will also change interest rate margins and will add to the health of the banking sector, which even in the face of changing monetary policy could still be very supportive of the economy. Even with changes in monetary stance it will take a long time before it is possible to return to the previous position. This gradual approach is also an element of optimism.

David Wright

David Wright (Chair) invited Jacques de Larosière to comment.

Jacques de Larosière

Jacques de Larosière noted, regarding the capital market in Europe, that he has a slightly divergent view from many in the Commission. The problem of the capital market is less a regulatory issue than it is a practical, operational or concrete issue.

In Europe it is usually believed that more regulation is needed in order to reduce the European legal obstacles or inefficiencies. An inordinate amount of energy is spent trying to agree new regulation. It is very difficult because each country believes it is right so there is not much progress. This is not the problem; it is not regulation. Europe does not have a proper capital market because investors are attracted more to foreign markets. The question is why. The Union has a payment surplus. It has an excess of savings, and those savings go away. They do not percolate much into Europe.

One of the reasons for this concerns interest rates. Jacques de Larosière asked about this on a previous panel and was not satisfied by the answer as an investor does not choose to invest because of remuneration and interest rates. However, if that candidate for an investment is taxed and told it is not going to bring anything to them in terms of remuneration and is going to be taxed by a negative interest rate, that is a major deterrent. Keynes was haunted by that problem. He used to say that interest rates must be low enough to allow the system to invest, but not too low because then there is a liquidity trap. A rational person who is told that putting money in a bond will not bring any remuneration will prefer to keep their money in liquid instruments, accounts in banks. This is happening every day. The figures provided by Eurofi are staggering. The portion of financial savings of households that is totally liquid goes up rapidly. Investment in longer-term obligations and the things approved of, such as climate change, do not attract any appetite.

If Europe wants to remain the only region in the world with negative interest rates, then it must be asked

why it would be thought surplus savings in Europe will remain and work there as long as they are not remunerated, whilst in other parts of the world the remuneration is significantly higher. The statistics of the Organisation for Economic Co-operation and Development (OECD) indicate that for the last 10 years the 10-year interest rate in the United States was steeper than the European one by 2%. That is very significant for an investor that has to prove to his client that he is doing a good job. It is okay to chisel at the regulations between the countries on capital matters, but if the basic condition to keep the money in Europe is not there due to this taxation of savings, Europe is not going to get anywhere.

It is thought there is a Banking Union because there is a unified bank supervisory system, and while that is true and a good thing it is not enough. The essence of a Banking Union is to allow bank groups to develop their business in single markets so they can capitalise on their strength in order to expand their activity. However, in order to do that the business model must be as consolidated, as universal or as global as the balance sheet. Ring-fencing of capital, owned funds and liquidity constraints at the host level lead to double buffering, inefficiencies and duplication in the use of capital whilst the unification of the balance sheet remains. The balance sheet is not for subsidiaries; it is at the global level. There is a discrepancy between the balance sheet of the group on the one side and the compartmentalisation of the business activity through ring-fencing.

Jacques de Larosière explained that friends in the banking sector had highlighted three matters that are difficult to understand. The first is the global systemically important banks (G-SIB) buffers and the alternative score. It should normally be calculated like in the United States on the basis of the Banking Union. The notion of the Banking Union involves group operating in different countries. The calculation should not be scattered among different host entities. However, this appears to be impossible in Europe, so it is a problem.

The second matter is the internal minimum requirement for own funds and eligible liabilities (MREL) obligations. They may well increase because of a new method related to the calculation of the deduction of own funds held in subsidiaries. This is a very technical point.

Lastly, the distribution of dividends in banking groups could also become a host decision and not a global decision for the bank itself. If the EU goes that far it becomes a localisation scattering and a division of the group in as many entities as there are subsidiaries, which is a major step backwards from the time Jacques de Larosière was familiar with when there was a Banking Union, but it was not called that. Now there is a Banking Union without the reality of a Banking Union.

David Wright

David Wright (Chair) asked Paschal Donohoe for his closing remarks.

Paschal Donohoe

Paschal Donohoe noted the importance of gradualism. When thinking about the Banking Union project, Paschal Donohoe and his fellow ministers put great effort into reaching agreement the previous year but were not successful for a number of reasons. The issue of gradualism in how to make progress is very important. A gradual and sequential approach needs to be taken to build something that currently is not strong enough in the project, and that is trust. There needs to be trust regarding how different stages are delivered and trust regarding how to move to the next stage.

Paschal Donohoe is a politician and represents politicians who are trying to reach agreement on a very complex and challenging project. The narrative about this, and the way to make progress, concerns how it is a source of better organising and directing savings and capital, not for the benefit of banks themselves but for the benefit of investment, jobs, living standards and the role of Europe in the world. That is the pitch. That is the paradigm. When thinking of all of the technical subjects in Banking Union, what has to be returned to is the purpose of the efforts, which is living standards, competitiveness and how to invest in a better future. There has not been enough progress in Banking Union recently because efforts have not been connected to that purpose.

Finally, as was acknowledge by all speakers, the progress already made with Banking Union should not be underestimated. At Irene Tinagli's committee in the European Parliament, when the progress of Banking Union is discussed Paschal Donohoe noted the efforts in that regard are amongst the reasons why, after two years of a pandemic, European banks are not part of the problem. They have shown that they are part of the solution. This is due to decisions the banks themselves took, but it is also due to the institutions in place through the efforts in Banking Union. With the efforts that the members of Eurogroup and all finance members involved in the Banking Union project are making, it is being demonstrated that this can be achieved. That is where the efforts will lie in the coming months.