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European Central Bank

Financial integration and stability: Towards a More Resilient Single EU Financial Market – conference on 26 April 2012

"Implications of macroeconomic imbalances and of the sovereign bond crisis for financial integration in the euro area"

It is a pleasure and a privilege for me to be here this afternoon to discuss the important issue of the implications of macroeconomic imbalances and of the sovereign bond crisis for financial integration in the euro area.

We know the macroeconomic context of the current sovereign debt crisis with its ingredients made of budget deficits and of balance of payments issues in various euro area countries.

I would like to focus my intervention today on the transmission mechanism between those macroeconomic imbalances and financial markets with the subsequent implications for financial integration in the euro area.

Two of the main factors of transmission of macroeconomic imbalances to financial markets over the past few years have been (and unfortunately still are):

1. The fact that by adopting the euro, euro area countries have given up their individual right to create money, that the E.U. is not fiscally integrated and that the European Central Bank is not allowed to monetize directly European States debts. This combination of factors has the consequence that there is no such thing as a risk free rate in the euro area.

2. The fact that moral hazard, i.e. the game of "heads I win, tails you lose", is everywhere in our financial system whether at a micro level between a simple trader and the bank employing that trader, at an intermediate level between banks and society (the well known "too big to fail" syndrome), or at a macro level between euro area member States and the "euro area community", if I may use this unorthodox expression.

The euro zone sovereign debt crisis has revealed over the past few years an otherwise well known fact: when a currency is not complete, there is no risk free rate and when there is no risk free rate financial integration is, at best, fragile as different markets will have a natural tendency to see their interest rates diverge as soon as macroeconomic imbalances emerge. In the euro area, this has materialized with vastly diverging interest rates in the various national debt markets.

As a consequence of the diverging rates seen on different euro area debt markets and of the fact that euro area banks bail-out authorities are still national, we are witnessing today a clear trend within European banks to refocus more and more on their domestic market. This phenomenon is by nature detrimental to financial integration in the area.

The biggest threat to financial stability in Europe today comes from the fact that euro area Member States are funded by banks that depend on the very States they are providing funding to for their own survival in case of bankruptcy (potential bail-out). In the world of spread sheets, this is called a circular reference and we all know that circular references simply cannot work.

One of the paradoxes of the situation created by the ECB's recent long term refinancing operation (LTRO) is that, for all the necessity to ensure a sufficient level of liquidity of the banking system, it has the consequence of feeding this circular reference. This is so because the combined implicit message of LTRO and of a capital requirement regulation that maintains the fiction that euro zone sovereign debts are risk free is that banks can buy massively sovereign debt without worrying about the possible negative consequences: they know that they will be bailed-out by the States they are funding if things go sour. We also see the inconsistency of a bank regulation based implicitly on the supposed risk free nature of sovereign debt in a euro area where risk free rates no longer exist. In the medium term, this can only be detrimental to financial integration. Finally, moral hazard emerges again through LTRO as private profits are generated by banks thanks to carry trades made possible by the public money made available to them.

All in all, and here again recognizing the benefit of relieving the liquidity constraint of European banks, the side effects of LTRO are 1) the increase of moral hazard in the euro area and 2) the incentive it gives to European banks to "retrench" in their home country, thereby harming financial integration.

We know that quantitative easing is not currently possible in the euro area given the legal framework under which the European Central Bank operates. But please allow me nonetheless to compare the respective effects of LTRO and quantitative easing: both have the consequence of easing the funding pressure of sovereign issuers but in the case of quantitative easing this is done through the direct monetization of public debt by the Central Bank with its mechanical inflationary consequence, whilst in the case of LTRO this is done at the cost of increased moral hazard and less financial integration. Each solution bears its own costs. Another potential positive dimension of LTRO is to provide liquidity to the banking system in order to help the financing of the real economy but current data seems to suggest that only a very limited portion of the € 1,000 billion made available through LTRO so far has actually gone to financing the European economy.

As the topic we are addressing today is the implications of macroeconomic imbalances and of the sovereign bond crisis for financial integration in the euro area, it may be interesting to make a comparison of the situations of the UK and Spain. The fiscal deficits and levels of public debt of those two countries are broadly comparable and, yet, the levels of their sovereign interest rates are simply not comparable. The reason for this situation is that there is a sterling risk free rate when there is no euro risk free rate. This, as we know, comes in turn from the fact that the Bank of England can monetize the UK's public debt when the European Central Bank does not have that power within the euro area. A similar comparison could be made between other euro area countries and, say, the USA or Japan.

Financial integration in the euro area is about private financial actors converging towards similar practices in similar situations in the different euro area Members States. But private financial actors' practices and financial architecture are obviously dependent on macroeconomic and general financial markets conditions. In that respect, measures such as the "excessive imbalance procedure" recently launched in the E.U. may be useful tools as they can contribute to controlling extreme imbalances threatening the whole system in the short run, but such measures can only be considered as second best measures: as long as the euro area does not have a risk free rate on which to base its financial system and as long as it accepts to be built on moral hazard, the ingredients of the next financial crisis and of its financial disintegration will remain, regardless of the ups and downs of fiscal discipline and of balance of payment equilibrium.

Thank you.

Thierry Philipponnat
Secretary General of Finance Watch
www.finance-watch.org

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