“Cross-border capital flows: theory and practice” - speech by Klaus Regling

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Speeches

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“Cross-border capital flows: theory and practice”

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Welcome to the ESM. It is good to see many familiar faces, and also several new ones. We have participants from the public sector and the private sector in the room, from the academic and the policy worlds.

This should be a good mix to address our topic: cross-border capital flows: theory and practice. This topic is important for the ESM. Cross-border capital flows and capital markets union are important issues for Economic and Monetary Union, and thus for the ESM.

In my short remarks I will first explain why this is the case. A better understanding of capital flows is important to help the ESM in our mission of maintaining euro area stability.

Secondly, I will look briefly at the data on capital flows in Europe, and what conclusions we can draw from them. Let me mention the most important conclusion right now. It is that financial integration in the euro area remains well below its pre-crisis levels. And this a concern for the ESM - and not just for us - because it stands in the way of economic risk-sharing. This is making the euro area economy less

resilient.

Finally, I will put this conclusion in the light of the euro area reform agenda. Many of the steps under consideration by the Eurogroup are aimed at fostering financial integration, and increasing economic risk-sharing. They would complete the comprehensive policy response the EU came up with after the crisis.

Information about cross-border capital flows can help us understand economic reality better, and guide our decisions on the policy reforms needed to make the euro area more robust. Why is that? Well, whenever cross-border flows are too big or too small, or excessively tilted towards specific assets or geographies, that can be a warning signal that some underlying structural problem or weakness in the economy is evolving.

An example was the remarkable widening of current account deficits in peripheral euro area countries in the early 2000s. At the time, some economists argued that, within a monetary union, the size of these current account imbalances, offset by capital account imbalances, did not matter. The reality was that the imbalances were flagging serious structural problems with competitiveness, and asset bubbles, fuelled by overheated internal demand and excessive credit growth.

This shows that capital flows can contain early warning signals of an upcoming crisis. So, as the crisis resolution mechanism of the euro area, it makes sense for the ESM to carefully monitor these data. That is not to say that capital flows contain the only possible warning signs. Other indicators that deserve close monitoring are fiscal sustainability and the functioning of labour markets, for example.

Detecting the next crisis early might help prevent it from happening. Needless to say, trying to achieve that goal is at the heart of what the ESM does. So, what are the data telling us? What can we learn from capital flows at the moment? That is the second topic I will address.

Historically, cross-border capital flows mainly reflected transactions of goods or services with other countries. Over time, however, the financial aspect of capital flows has taken on a massively bigger significance. Capital flows have increased much faster than world GDP over the last decades. For instance, in 2015, the size of the euro area financial sector was 6 times that of GDP. At the beginning of the century, it was only 4 times bigger. If you go back a few more decades, the

relationship was one-to-one, or even lower.

This dramatic rise coincided with the liberalisation of global capital markets and corresponds to the exponential rise of new financial instruments serving risk management or speculation purposes. With the beginning of the global financial crisis in 2007-08, the rise of the global financial market collapsed and financial integration in the euro area still hasn't recovered from the damage inflicted by the global financial and the euro debt crises.

The ECB publishes a comprehensive gauge of euro area financial integration. The index went up rapidly in the decade between the start of the monetary union and the crisis. It crashed during the crisis. And while it has recovered materially since 2012, it is still well below its pre-crisis peak. In other words, banks and investors have retrenched behind national borders and their home bias remains much larger than before the crisis.

At the same time, integration of the real economy is improving again. Trade flows have accelerated recently, after a number of years during which global trade slowed down materially, both relative to its historical performance and to overall output growth. In fact, the last IMF estimates suggest that global trade growth this year will be the highest since 2012, and grow at a faster pace than world GDP. That is a big swing relative to the last years, when global trade grew at a slower rate than global GDP.

Of course, trade flows face significant risks ahead, as the risk of protectionism rises, and not just in the U.S. For today's workshop, the more important immediate question is why the lack of financial integration is a problem.
First, and this is something the ECB often stresses: financial integration fosters the smooth and balanced transmission of monetary policy throughout the euro area.

The second problem is that poor financial integration is an important cause of weak economic risk sharing in the euro area. Economic risk sharing allows for a better smoothing of output fluctuations within an economic region. It makes it easier to deal with asymmetric shocks, and renders the region more resilient.

In the euro area, economic risk-sharing is underdeveloped compared to the United States, but also to large member economies such as Germany or France. This is the case not only when looking at overall risk-sharing. But also when looking at the two

separate channels through which risk sharing can take place: the fiscal channel and the private markets channel. Both are much weaker in the euro area than in the U.S.

In my view, promoting euro area risk-sharing is the overarching objective when we consider the next steps to make the monetary union more robust. The fact that trade is starting to recover while financial integration remains subdued suggests that some policy change may be needed on the financial side to promote risk sharing.

Much of the euro area reform agenda which is now under discussion is aimed at achieving exactly this goal of increasing risk sharing through more financial integration. So in the final part of my speech, let me put the euro area reform agenda against this background.

The changes that have been proposed are on the financial, the fiscal and the institutional side. The first two would have an impact on economic risk-sharing.

The fiscal and the financial sides of the economy both offer channels to enhance risk sharing. There is a trade-off between the two. The more risk is shared through the private channel, the less fiscal risk sharing is needed.

The completion of Banking Union is an important step on the financial side. As you know, two further steps are under discussion to complete banking union. The Single Resolution Fund needs a financial backstop. The situation we need to achieve in the euro area should be comparable to the U.S., where the FDIC is backstopped by the Treasury.

The banking union also needs a common deposit insurance. This would reduce the risk of a nation-wide bank run in a euro area country. Establishing a backstop for the SRF and a common deposit insurance are not in themselves controversial issues. What is politically more contentious, are the conditions that have to be put in place before these two steps can happen.

One conditions is that banks need to become more profitable and clean up legacy problems. Non-performing loans must decrease faster. Healthy banks will not pay for others. So the NPL initiative at the EU level is very welcome.
Other examples of risk reduction are the build-up of regulatory capital that is still required, the full implementation of the Basel III capital requirements, further

regulatory harmonisation, the review of internal risk models, and – very controversial – the reduction of sovereign bond holdings in the balance sheets of banks. After de-risking, completing Banking Union will be possible and an important step towards a less fragmented banking industry and more economic risk sharing through the private sector.

Fiscal facilities could also help to promote risk sharing. But it is important to begin by saying what the euro area does not need on the fiscal side for a smooth functioning of monetary union and a healthy euro, in my view. You sometimes hear that a single currency cannot function without a full fiscal union, or a full political union. But these are neither politically feasible, nor economically necessary.

We don't need additional transfers between countries. The existing EU budget already allows for significant transfers from rich to poor countries, which promote real convergence. They can be significant, up to 4 percent of the receiving country's economy.

Europe also doesn't need a new instrument to fight deep symmetric shocks. The current rules already offer enough room to manoeuver in a deep crisis. The simultaneous increase in fiscal deficits during the global financial crisis of 2008/09 has shown that.

Where I see a real gap on the fiscal side is that the monetary union does not have a macroeconomic stabilisation function, or a facility to deal with asymmetric shocks. Such a function could be useful to avoid bigger problems. Also because the ECB cannot do anything to tackle asymmetric shocks. Monetary policy affects the euro area as a whole.

There are proposals for such a facility that would not lead to permanent transfers or debt mutualisation. Such as U.S.-style rainy day funds, a complementary unemployment scheme, or shorter-term ESM loans with lighter conditionality.

Importantly, the money would not come out of an annual budget. Instead, such a facility would be a pot of money or a credit line that would only be activated when needed, and would have to be repaid within an economic cycle. It should be a revolving fund.

On the institutional side, let me just mention the possibility of a European Monetary

Fund. The IMF played a major role in the beginning of the euro debt crisis, but that role has since diminished.
It now looks unlikely that the IMF will be involved in future euro area programmes and the ESM could take over that role. That was the conclusion in the discussion of the Eurogroup in October.

Rather than have a group of four creditors, ESM and the European Commission would then have the mandate to design, negotiate and monitor rescue programmes together.

These tasks, together with managing a limited fiscal capacity for stabilisation, and possibly some involvement in a debt restructuring framework, would justify changing the ESM's name into EMF.

But this goes beyond the scope of this workshop. You will discuss capital flows and capital markets union today. I look forward to the outcome of the conference, which as I said will help us understand capital flows better and facilitate the ESM's mission.

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