POST-COVID PRIORITIES

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"Look up": a Financing Union, at last, to fund a greener and more digital post-crisis Europe

Two years ago, the Covid crisis broke out and called for a strong response from public authorities, for which the financial sector acted as an efficient transmission belt to the real economy. However, despite its resilience, our European banking and financial markets remain deeply fragmented. As we can now reasonably hope to exit the pandemic, it is time for firefighters to hand over to architects.

The Banking Union and the Capital Markets Union (CMU) would both enhance risk sharing within Europe and improve private stabilisers, which are just as important and efficient as public ones – and less divisive than this common fiscal capacity – in addition to our successful monetary Eurosystem, a financial Eurosystem should now see light.

The Banking Union is crucial to create large pan-European banking groups, raise their profitability thanks to scale effects and better face up to foreign competition. And yet after a strong initial push in which we built an effective first pillar (supervision) and achieved important work on the second pillar (resolution), Banking Union is now on hold. We need to move forward again, breaking the "EDIS deadlock", with simultaneous and parallel movements on several fronts. We should not focus on the creation of new instruments, but rather try and make existing ones work better.

First and foremost, we have to move beyond home/host issues, for instance via the broader use of cross-border liquidity waivers as currently allowed by the regulation, and ideally new waivers for intra-group MREL and capital requirements. A system of workable guarantees between the parent company and its subsidiaries, a preferential treatment for intragroup exposures, and / or a more extensive recourse to branches rather than subsidiaries are other paths to explore.

In designing future solutions, we naturally have to foresee worst-case scenarios including the possibilities of a bank's resolution or insolvency. This entails finding realistic alternatives to EDIS, for instance a scheme where foreign subsidiaries would be affiliated to the home deposit guarantee scheme. Resolution tools could be used for small and medium banks too, without increasing the size of the Single Resolution Fund. Liquidity in resolution could be provided by the Eurosystem, intertwining with the issue of the guarantee framework that must support this facility.

The CMU is the natural complement to the Banking Union: capital markets and banks together provide diversified sources of financing, offering both safety and flexibility to economic agents. From a central bank point of view, a deeper and more integrated financial system is desirable, as integrated capital markets help absorbing asymmetric shocks and improve the transmission of our single monetary policy to all parts of the euro area.

The good news is that the euro area has abundant savings: the surplus of domestic savings over investment structurally exceeds to EUR 300 billion. Yet the world's largest pool of savings is not sufficiently channelled to productive investment, and the EU keeps lagging behind Asia and the United States in terms of innovation. We can measure this lag in venture capital – the most suited way to finance and accompany the development of young and innovative companies. Over the last decade, fundraising by the ten biggest European funds (including the UK and Switzerland) represented only 15% of the ten biggest US funds.

Rather than a collection of segmented national markets, Europe has to transform – at long last – into a seamless single market.

The Commission launched a new CMU action plan in September 2020, with several items that are all welcome and relevant. The main issue at stake now is to ensure its concrete implementation. More broadly, the success of CMU and BU does not depend on an ever-improving technical agenda; it depends on a much stronger political impetus. To this end, we should rebrand the CMU in a way that better reveals its goals: financing the digital and ecological transformations.

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NADIA CALVIÑO

Vice-President and Minister for Economy and Digitalization, Spain

A renewed EU fiscal framework for the future

There is a growing consensus on the need to reform the EU economic governance framework. The review process was launched before the pandemic, in view of the clear shortcomings of the system in terms of complexity, coherence and alignment with economic reality. Since then, the unprecedented shock and its deep impact on the economic, social and fiscal stance of most countries has made it clear that we need to update our rules and procedures in order to make them future proof.

This review can build on the historical response to the pandemic, which has opened a new outlook on how to reinforce our policy coordination and improve its effectiveness. We have deployed an unprecedented coordinated response at national, European and global level that hat has been key to preserve financial stability, to protect businesses and employment and to allow for a fast recovery. Our economies and societies have also undergone a significant transformation and new challenges have emerged.

Discussions are expected to intensify in the upcoming months and, to succeed in this crucial task, we will need to avoid the divides of the past. There is an important lesson from the experience of this crisis that we should bear in mind as we move forward: we are all on the same boat, and united we are stronger. Entrenched positions will not get us far. This is a future-oriented discussion and we need a forward-looking approach based on the broad consensus emerging. Certain elements will be particularly important going forward.

First, our starting point is one of substantially higher debt-to-GDP ratios than before the crisis. In order to be ready for the next shock, we need to create fiscal space. In fact, a responsible fiscal policy in Spain has allowed for an important reduction of deficit and debt to GDP ratios already in 2021. We will continue on the same track of fiscal responsibility in the coming years, benefitting from strong GDP growth. However, in a context of higher debt levels across EU Member States, we should reinforce public finances in the long term with a realistic and pragmatic fiscal framework. We need a pragmatic and country-specific approach for fiscal consolidation to be credible and effective. Debt reduction should be realistic, gradual and sustained, compatible with economic growth and job creation in order to ensure fiscal sustainability.

Second, in the coming years, we will also need to undertake an unprecedented investment effort to drive the necessary green and digital transitions. In previous crises, public investment and other growth-enhancing expenditure were the first victims of fiscal consolidation policies. Spain is a case at hand, as public and private investment dropped in the six years following the outbreak of the last financial crisis and it never recovered, dragging potential growth and prosperity for several generations. These strategies proved to be ineffective, leading to a protracted underinvestment, weakening potential growth and social welfare and jeopardizing fiscal consolidation efforts.

The ambitious objectives of EU Green Deal and the EU Digital Strategy will require an unprecedented amount of public and private investment by 2030. While indeed Next Generation EU will partly cover these needs during the first years of the transition, nationally financed public investment will also increase. The fact that we are all on the same boat is particularly relevant in this regard. When it comes to climate change, for instance, our citizens would not understand that necessary investments are delayed in some countries because of insufficient fiscal space. This is a shared challenge and an issue of intergenerational fairness that requires a decisive common response. Moreover, leading and succeeding in these structural transformation processes is an essential element of our strategic autonomy and our future role in a fast changing and challenging international context.

“We should reinforce public finances in the long term with a realistic and pragmatic fiscal framework.”

Third, we need to draw lessons from recent experience. Contrary to the controversial approaches of the past, the national ownership of investments and reforms of the Recovery and Resilience Facility and its multiannual approach can be a very useful source of inspiration to promote a virtuous circle with improved enforcement and impact of fiscal strategies.

Fourth, timing is crucial. We need a renewed framework by 2023 and we have no time to lose. We cannot go back to the old rules. They were not fit for purpose before the pandemic and cannot be applied as such in the new reality.

All in all, by 2023 we need a growth-friendly fiscal framework that reinforces financial stability, supports the recovery and job creation and is adjusted to the specific circumstances of different countries. Spain will continue to contribute active and constructively to this fundamental process, that will determine the scope of the post-pandemic economic cycle and the standing of the EU in the new geopolitical landscape.

KLAAS KNOT
President, De Nederlandsche Bank (DNB) & Chair, Financial Stability Board (FSB)

The global impact of European regulation

After the global financial crisis, the Financial Stability Board (FSB) coordinated a comprehensive reform program. These reforms, which promoted close cooperation and strong international standards, strengthened the financial system and made it more resilient to withstand the economic shock from Covid-19. Economic developments and structural changes will continue to pose new challenges in the coming years. In its work program, the FSB will focus on the pandemic recovery as well as long-term structural changes within the financial system. This article discusses how the regulatory agenda of the EU could play an important role in these discussions and catalyze further reforms to enhance global financial stability.

When the Covid-19 crisis erupted, financial institutions were in a much better position compared to 2008/2009 to absorb losses and continue lending to the real economy. As a result, the financial system did not create the same amplification effects that we saw during the global financial crisis. Nonetheless, the vulnerabilities experienced within the non-bank financial sector provide new lessons for the regulatory framework. In addition, the pandemic accelerated fundamental trends such as digitalisation. Moreover, the necessary extraordinary fiscal and monetary support measures have increased underlying vulnerabilities associated with search for yield, economic divergence and public and private indebtedness. From its cross-sectoral and global perspective, the FSB plays a central role in monitoring these developments and coordinating the international response. The EU can contribute to these objectives in various ways.

First of all, the EU has always been – by nature – a strong partner in fostering international cooperation and high-quality minimum standards among jurisdictions. The EU should aim to lead by example by implementing reforms in a comprehensive and consistent manner. A harmonized approach can sometimes involve a trade-off with practical challenges in specific regional circumstances. However, any differences need to be balanced against the need for a global perspective and keep in mind the objective of maintaining a level playing field. In this context the EU could make further progress in implementing the Basel III standards in accordance with the internationally agreed framework.

Second, the EU can play an active role in implementing the lessons from the recent crisis. The immediate challenge is to facilitate an orderly exit from the different support measures without creating shock effects or scarring the economy and bearing in mind the risk of spillovers to other countries from uncoordinated actions. In addition, supervisors need to strengthen the regulation of non-bank financial intermediation (NBFI), which experienced a short, but intense period of stress in the initial phase of the pandemic. The FSB is coordinating international policy efforts to make the NBFI sector more stable and to mitigate liquidity risks that can emerge during stress. In addition, the economic divergence within Europe during the Covid-19 crisis has once again highlighted the unfinished agenda of completing the European banking union and breaking the interconnectedness between governments, the domestic banking sector and non-financial corporates. Additional measures are also needed to develop the European Capital Markets Union and facilitate private risk-sharing.

How can the regulatory agenda of the EU catalyze reforms to enhance global financial stability.

Finally, the EU can play a leading role in supporting the transformation of the financial system. For example, the EU is ahead of the curve with the development of a green taxonomy and incorporating climate risks into day-to-day supervisory activities and stress tests of the Single Supervisory Mechanism (SSM). The financial sector can play an important role in combatting the effects of climate change. Another challenge of a clearly global nature, is the crypto-asset market, which is growing fast and becoming increasingly connected to the traditional financial sector. The FSB will examine both unbacked crypto-assets and stablecoins to monitor risks to financial stability and to identify regulatory gaps. Experiences within the EU with the development of the Markets in Crypto-Assets Regulation (MiCAR) can provide valuable input for these discussions. More broadly, the digitalisation of the financial sector will bring new risks to financial stability worldwide and will require new and harmonized regulatory approaches among jurisdictions.

I am convinced that an ambitious EU approach that builds upon ongoing international efforts will strengthen the European financial system and reinforce global financial stability. From an FSB perspective, I would therefore encourage continued close interaction and cooperation to meet these new challenges.

MÁRIO CENTENO

Governor, Banco de Portugal and Member of the Governing Council of the ECB

Post-pandemic monetary and fiscal policy and EMU deepening

Over the coming years, the policy action must combine short-run stabilisation with a robust long-run institutional setup. In the euro area, despite the improvement in the crisis response apparatus since the financial crisis, fragilities persist. Coupled with the scars from the pandemic and its uneven effects across sectors and economies, the institutional fragilities may hamper economic growth and limit financial integration.

Monetary policy should safeguard the transmission mechanism, while pursuing the primary objective of price stability. It should make use of the flexibility enshrined in the purchase programmes, guaranteeing a gradual pace for the future normalisation. This is not to say that monetary policy should abstract from the recent surge in inflation, but there are strong reasons for keeping a steady-hand.

First, it is hard to argue that its drivers are "monetary", imprinting inflation expectations and contributing to disanchoring.

Second, despite excess demand in some markets, we are witnessing a natural process of relative price adjustments, reflecting relative scarcities, and adjustments towards a decarbonized economy. Still, well-identified and arguably temporary supply bottlenecks are part of the story.

Third, although a strong recovery in demand would eventually call for a policy response to restrain demand and refrain the surge in inflation, there would be welfare costs and, foremost, unsurmountable coordination aspects beyond the reach of monetary, and I dare say, fiscal policies. Such response could delay the adjustments in supply and hence to inflation. Embarking in a generalized restrictive loop, when we face exogenous shocks, will not help the economy overcome these challenges. Overall, the review of the ECB's monetary policy strategy has just confirmed its medium-term orientation, as "the appropriate monetary policy response to a deviation of inflation from the target is context-specific and depends on the origin, magnitude and persistence of the deviation".

Fiscal policies should address possible asymmetries in the recovery. However, it is important to start a gradual transition towards a neutral stance. Whereas the current environment of low interest rates may favour the effectiveness of expansionary fiscal policy, it remains important to strike the right balance between stabilisation and sustainability, ensuring a sound interaction with monetary policy. The fiscal strategy should be prepared for a transition towards the normalisation of monetary policy. In this context, it is reassuring that initiatives taken under the NGEU instrument offer ample opportunities for a sustained recovery process. Their effectiveness will depend on channelling funds towards high quality and productive investment. It is now up to the Member States to deliver upon this extraordinary moment of European integration and solidarity. Failing would weigh on the future of Europe.

The milestones of an agenda for a long-run institutional setup are known, but lack consensus on their relative importance and prioritization. Evolving conditions and challenges shift priorities, but the main features are consensual. Climate and digital transitions will influence implementation, but, above all, will benefit from it. The establishment of a complete banking union in all its three pillars, the review of the crisis management framework and the implementation of the capital market union should continue to be part of the financial agenda. Progress should accommodate worries and concerns from all sides, but must be steady. On another front, fiscal risk-sharing is also desirable. Coordination of fiscal policies among member-states is insufficient.

[...] policy action must combine short run stabilization with a robust long-run institutional setup.

It is fundamental to build on the NGEU and aim for common debt and budgetary instruments that have proved their success. The approval of the Budgetary Instrument for Competitiveness and Convergence before the pandemics was a huge step, reflected already in the NGEU framework and financing. We should not rest on these glories, but make further progress towards a truly European institutional landscape, without dead-ends or rough cliff edges.

One of the lessons of this crisis is that monetary and fiscal policy can coordinate naturally, and hence mutually reinforce each other. Preserving the autonomy of both policies while contributing to the welfare of our citizens is possible and desirable.

VITORIO GRILLI
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J.P. Morgan

EU financial integration through the CMU and Banking Union

Over seven years have passed since the European Commission's Green Paper on Capital Markets Union (CMU), and ten years since the launch of the Banking Union. JPMorgan has been a strong supporter of the goals of both since their inception, which is about developing a more diversified financial system with deep capital markets complementing healthy bank financing. This should enable cross-border investment without barriers, and allow businesses to more easily raise funds. I have personally invested in both initiatives, during my time as Italian Finance Minister and as a member of the Commission's CMU High-Level Forum.

The EU has made strong progress on both, having finalised legislation on securitisation, covered bonds and private pensions, and with the creation of the single supervisory and resolution mechanisms.

A report last year from AFME shows that there was record levels of capital markets funding supported EU businesses in the first half of 2021, reflecting significant recapitalisation needs in response to the pandemic and favourable conditions for raising capital. In particular, European primary capital markets continued to expand during the first half of last year for the third consecutive year, with the proportion of markets-based funding for EU corporates rising to 16.8%. Capital markets funding to European SMEs has also grown at a record rate.

Considerably more banking activities that used to be conducted from London are now conducted from the EU27. For example, at JPMorgan, we have recently completed the consolidation of our EU presence into a single legal entity, known as J.P. Morgan Societas Europaea (JPMSE), which operates a network comprising 14 branches across the EEA and the UK, making us among the top 20 ECB supervised banks with a total capital base of around €34 billion.

Aggregating across the whole industry, this built-out is considerable. The thinktank NewFinancial has produced research showing that more than 440 firms in the banking and finance industry have relocated part of their business, that banks have moved more than £900bn in assets, and insurance firms and asset managers have transferred more than £100bn in assets and funds. This roughly tallies with the €1.2 trillion in banks assets (£1.05tn) that the ECB says banks have agreed to move. Final numbers will likely be larger.

But more work is needed to improve EU financial market integration. Last November, we had a "mini-CMU" package, which included legislative proposals to reform ELTIF and to create a European Single Access Point which would establish a European-wide company data registry system. These could help move the needle. We are also expecting further proposals in the coming months on securitisation, which we think is a bridge between the CMU and the Banking Union. When developed in such a way as to be responsible, prudentially sound and transparent, securitisation can be an important vehicle to increase the capacity of banks to lend, especially to SMEs, and also for investors to have access to European credit products.

Going forward, it will also continue to be important that the EU remains open to international financial markets. The participation of global firms in the EU system brings added competition and market depth, to the benefit of EU clients. Non-EU firms increase diversification and resilience of financial services provisions in case of disruption affecting EU firms. JPMorgan, for example, increased its lending by over 20% between 2019-2020, indicating our commitment to Europe in a time of difficulty.

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It is reassuring that recent initiatives from the European Commission recognise the importance of international cross-border practises, such as third country branches and the delegation of portfolio management to third countries, which has contributed to the success of UCITS on a global scale. We are hopeful that this same approach will be adopted when it comes to the use of so-called national access regimes, which EU corporates use to optimise their capital raising and financing.

There will unlikely be a moment when the CMU nor the Banking Union are declared "complete". Instead, they will be ongoing processes, with progress depending on incremental steps, continued political momentum as well as the avoidance of 'pitfalls' that could be detrimental to cross-border market financing. We will continue to build.

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Highlights of the G20 Work in the financial area under the Italian Presidency

Italy took up the G20 Presidency in the midst of the pandemic crisis, when global economic activity while recovering was still far below its pre-Covid level. Thanks to the extraordinary public support extended to households and firms and to the prompt coordinated reaction of monetary and other financial policies to the crisis, in 2021 the world experienced a strong recovery. The rapid roll-out of vaccines in developed countries led to a gradual lift-off of restrictions to economic activity and to a resumption of investment and consumption, with much fewer bankruptcies than expected.

Many advanced countries have reached or are close to pre-crisis output levels although the recovery remains vulnerable to risks owed to an evolving pandemic, persisting supply-side bottlenecks, and diverging economic outcomes.

Under the Italian Presidency the G20 took actions to help the weakest economies hit disproportionally by Covid-19. It provided support to multilateral mechanisms ensuring wide access to tests and vaccines. It established a new Panel on prevention and preparedness which advanced proposals to improve the mobilization of funding and enhance coordination between Health and Finance Ministries and international organizations. Work to deliver a shared solution will continue in the next months.

The G20 also agreed to suspend debt service payments for 50 countries and to make available 650 billion dollars in additional reserves through a general SDR allocation. Follow-up work aims to develop actionable rechannelling options which will allow low income countries to receive further support.

On international taxation, to address fairness issues posed by globalization and digitalization the G20 endorsed an important agreement which sets rules for the reallocation across jurisdictions of taxes on excess profits of multinationals and introduces a minimum level of taxation. Work on implementation will be completed by 2023.

The Italian Presidency also focused on longer term economic drivers, in primis the fight against climate change, giving priority to the issue of sustainable finance. It promoted the creation of the Sustainable Finance Working Group under the leadership of the United States and China as a permanent mechanism for coordinating the mobilization of resources to finance the transition and mapping future G20 work through its Roadmap. In 2021 it concentrated on strengthening the approaches for aligning investments to sustainability goals and on overcoming informational challenges by improving reporting and disclosure. A further initiative is the request to the IMF and other international organizations to consider climate-related data needs in preparing a new Data Gap Initiative.

The growing digitalization of payment and financial services during the pandemic offers opportunities but brings risks for financial inclusion. Under the Italian Presidency the Global Partnership for Financial Inclusion co-chaired by Italy and Russia focused on these risks and developed a menu of policy options for enhancing financial consumer protection and financial education; its work also targeted the facilitation of remittance flows and the reduction of transfer costs. A related workstream concerns the Roadmap for enhancing cross-border payments. In 2021 the G20 achieved consensus on a set of ambitious targets for costs, speed, access and transparency of these payments that will help measure progress in the main areas of intervention. The implementation of the Roadmap will be taken forward according to its milestones and timelines.

Sustainable finance and NBFI resilience were among the priorities of the Italian G20 Presidency.

The Italian Presidency focused on two further issues concerning financial stability. One relates to the outcome of the analysis of the performance of the financial system faced with its first test of resilience since the global financial crisis which shows that the regulatory reforms of the past decade have made the financial system more robust, although some issues and gaps remain to be addressed. The other concerns the efforts to strengthen the resilience of the non-bank financial intermediation sector (NBFI): the G20 achieved a consensus on an agreement to assess and address money market fund vulnerabilities in their jurisdictions, using the framework and policy toolkit set by the Financial Stability Board. Further work will be conducted to improve NBFI risk monitoring and mitigate liquidity risks in open-ended funds.