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International role of the European financial system: a macroprudential perspective

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**General Board, European Systemic Risk Board, and co-chair of two of its committees. None of these bodies has any responsibility for views expressed, which are entirely my own. This presentation does draw, however, on the forthcoming ESRB Report, 'Global dimensions of macroprudential policy'. I am grateful to ESRB colleagues for their input.*

Road Map

- Risk channels associated with global financial integration for EU economies
- Role of global and EU variables for the conduct of macroprudential policy at EU and national level.
- Macroprudential policy options available to EU authorities to address risks associated with the international dimensions of the EU financial system.
- A footnote on the international role of the euro

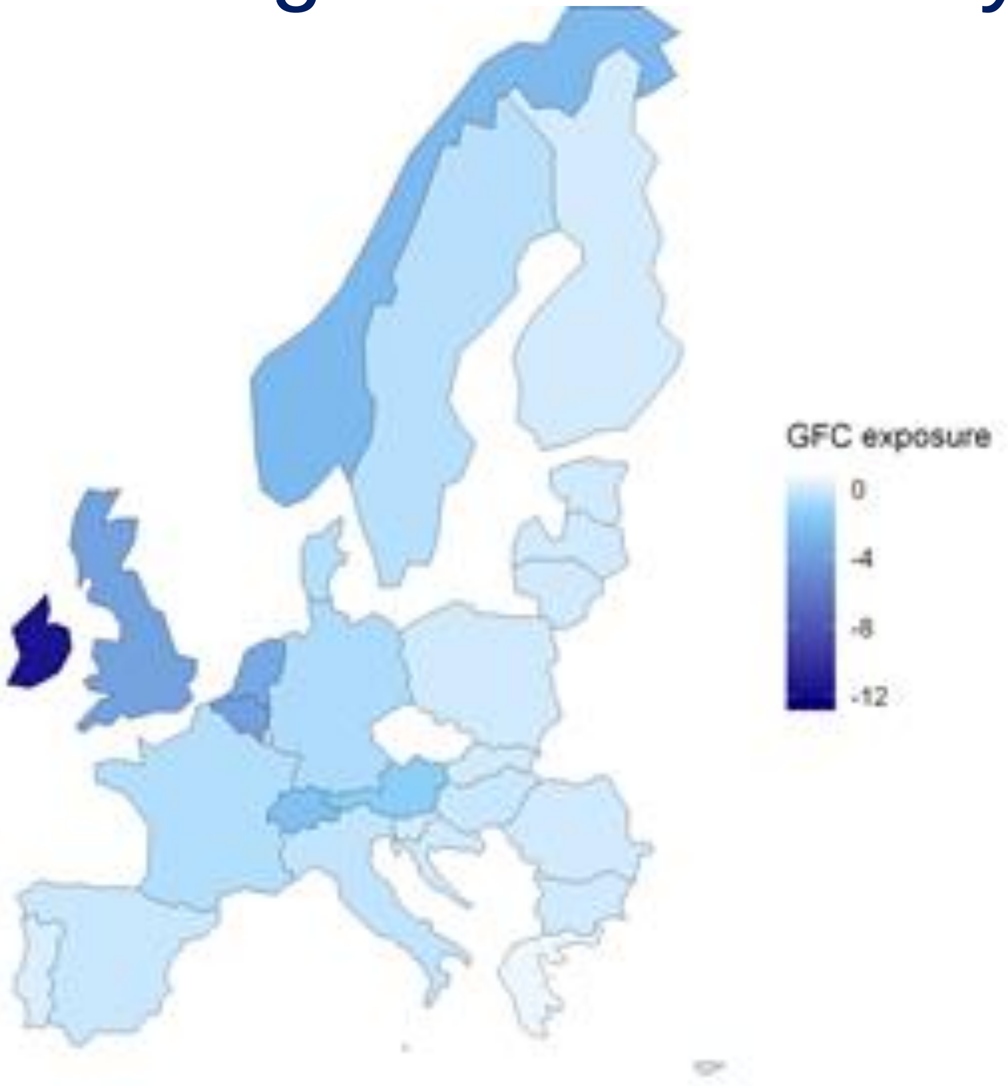
Global and domestic cycles

- Domestic financial cycles are influenced by a global financial cycle in capital flows, asset prices and credit.
  - Increasing vulnerability of domestic economies to outside shocks
- Global financial cycle driven by global risk aversion and financing conditions (including monetary policies) in the core economies.
  - US, euro area, China, Japan, UK
- Externalities transmitted from the core economies to the rest of the world, with ‘second-round’ feedbacks.

Exposure of EU economies' capital inflows to the global financial cycle

Data 1990Q1-2018Q3. Capital flows normalized by GDP. Map shows country-specific response intensity of total gross capital inflows (as % of GDP) to a one standard deviation shock in global risk (using Habib-Venditti [2019] global financial cycle indicator).

Source: IMF International Financial Statistics, Habib and Venditti (2019) and ESRB calculations.



US, EU and China in the global financial landscape

US

- Foreign demand for US 'safe' securities
- Large trade and current account deficits
- Higher return on external assets than on external liabilities

EU

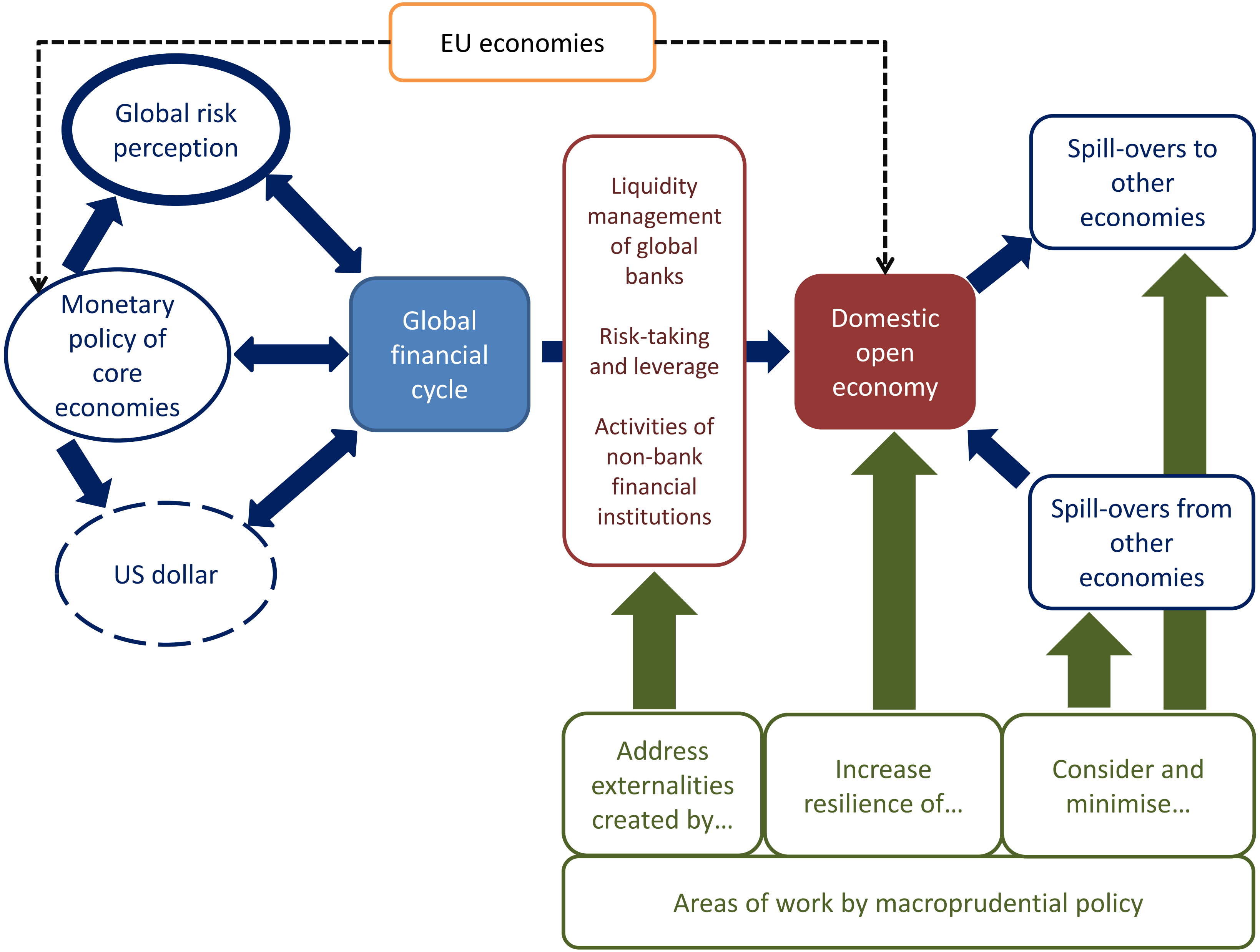
- Core economy but policies (except euro area monetary policy) are national
- Large trade and current account surpluses
- Low return on external assets
- Different ECB rates and non-euro area rates → intra-EU flows

China

- Growing role in the world economy
- Importance of its monetary and exchange-rate policies for other EMEs? An Asian currency bloc?

Search-for-yield behaviour

Global dimensions of macroprudential policy



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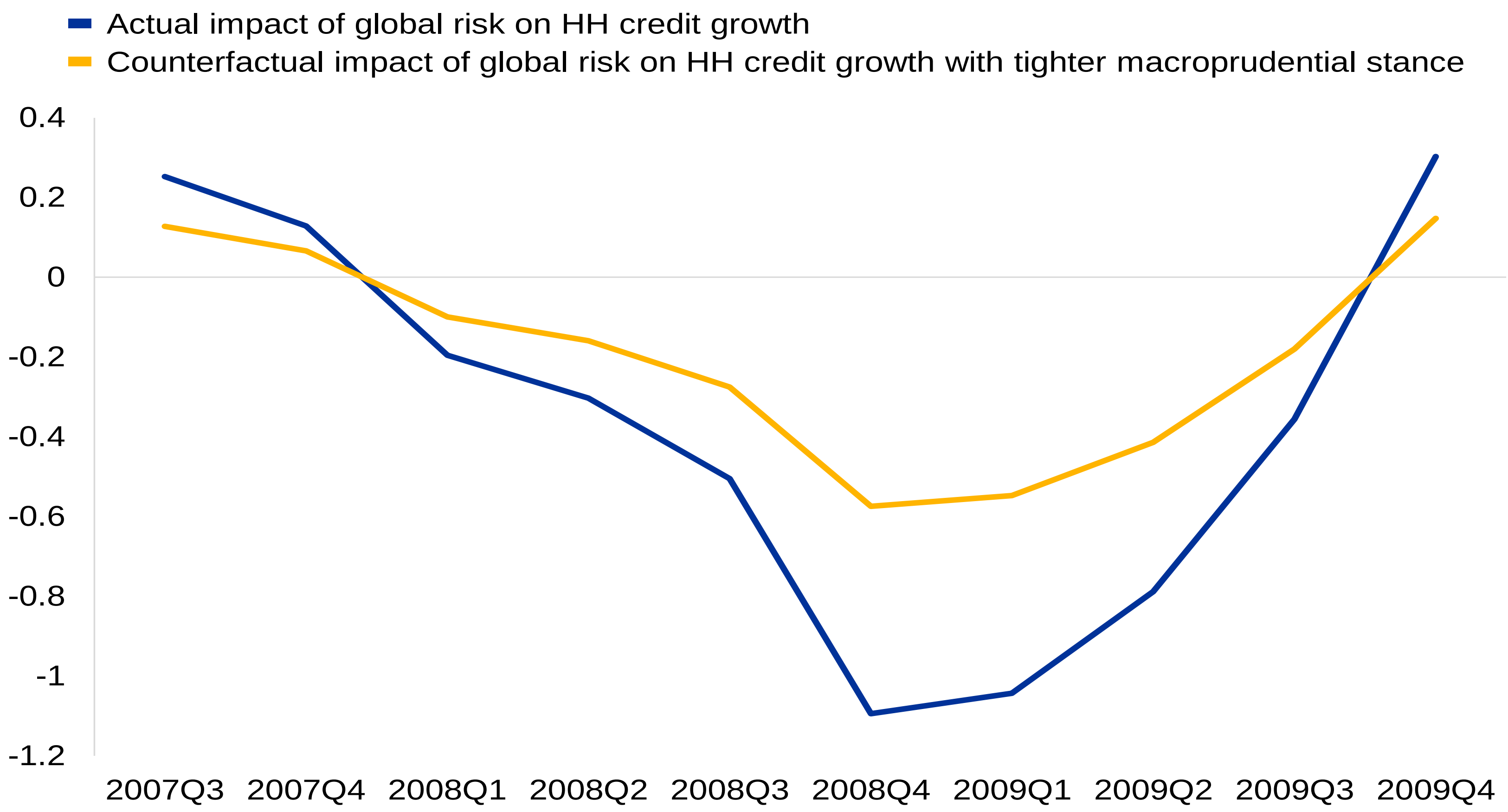
Counterfactual analysis of the impact of EU macroprudential policies on transmission of the global financial cycle during the financial crisis



Based on estimation results in ESRB (2020), this compares the actual impact of a shock to global risk on (average) household credit growth in EU economies with the impact in a counterfactual scenario assuming that the 2017 macroprudential stance in EU economies was in place at the beginning of the crisis. The EU macroprudential stance in 2017 is defined as the cumulated change in the macroprudential indicator of Alam et al. (2019) in the period 2015Q1-2016Q4, averaged across EU countries.

Financial institutions as generators, transmitters and receivers of global systemic risk

- Cross-border activities of global banks
  - Liquidity management: “flight home” effect in periods of stress, internal funding instead of volatile interbank funding.
  - Leverage and risk-taking: risk-taking channel of monetary policy of core economies becomes global
  - Funding and borrowing costs depend on monetary conditions in core economies.
  - Currency channel: changes in FX rates and FX assets/ liabilities, balance sheet effects.
  - Capital flows: bank flows dominant pre-crisis, *retrenchment since, especially by European banks*
- Increasing role of non-bank financial intermediaries
  - Stronger cross-border linkages than banks – particularly active in wholesale funding markets, sensitive to global liquidity conditions
  - Participation in the risk-taking channel of monetary policy.

EU large financial institutions

- Europe has 13 G-SIBS: 1 bucket 3, 3 bucket 2, 9 bucket 1

  (US: 1 bucket 4, 1 bucket 3, 3 bucket 2, 3 bucket 1)

- Not only European banks are important – European NBFIs are also significant and may have strong interconnections with banks
  - of the 25 largest asset managers in EU, 14 are owned by European banks, 5 by European insurers (but top 7 AM globally are all US-based)
  - of 128 banks reporting to EBA at end-2015, over 60% of their exposures to NBFIs were to entities outside EU (hence outside EU regulatory perimeter)

Macroprudential policy in an open economy (1)

- National macroprudential policy in the EU, but EU-wide policies can have a global impact.
- Importance of enhanced monitoring of monetary developments in core economies that might have systemic effects in EU economies through global financial cycle.
- Conversely, need greater attention to spillovers from EU monetary policies to rest of world and feedback onto EU.
- Capital flows are a key transmission mechanism. OECD Code of Liberalisation and IMF Institutional View permit capital flow management policies (in EU, vis-à-vis non-Member States) to achieve financial stability objectives under certain circumstances.

Macroprudential policy in an open economy (2)

- Evidence on the effectiveness of macroprudential policies to mitigate the domestic financial cycle and the transmission of the global financial cycle.
  - Adrian et al. (2016), Avdjiev et al. (2017), Aizenmann et al. (2018), Takáts and Temesvary (2019),.
  - Counterfactual exercise by Aikman et al. (2019).

- In the EU, possibility to set up CCyB for exposures to third countries: increase resilience to external developments
  - Macroprudential monitoring of core economies.

Addressing leakages and spillover effects

- Empirical literature finds leakages and outward spillovers of macroprudential measures.
  - Magnitude and direction of effects vary.
  - Geographical distance attenuates effects.
- More prevalent in banking sectors with a strong presence of foreign branches.
  - Policy measures in the US and the EU to address potential spillovers and leakages from branches of third-country banks.
- Rationale for stronger cross-border coordination of macroprudential policies.
  - Difficult to achieve globally, but *possible at regional (esp. EU) level*.

Important topics for further work

- Would stronger, more centralized EU macroprudential policies strengthen international role of European financial system?
- CCyB for exposures to third countries: more detailed monitoring of developments in core economies?
- Policy coordination: reconsider some parts of the reciprocation framework? How could policy coordination be enhanced?
- Cross-border exposures of non-bank financial intermediaries`
- Macroprudential toolkit for global NBFIs? – taking account of variety of business models and institutions – could Europe take lead here?

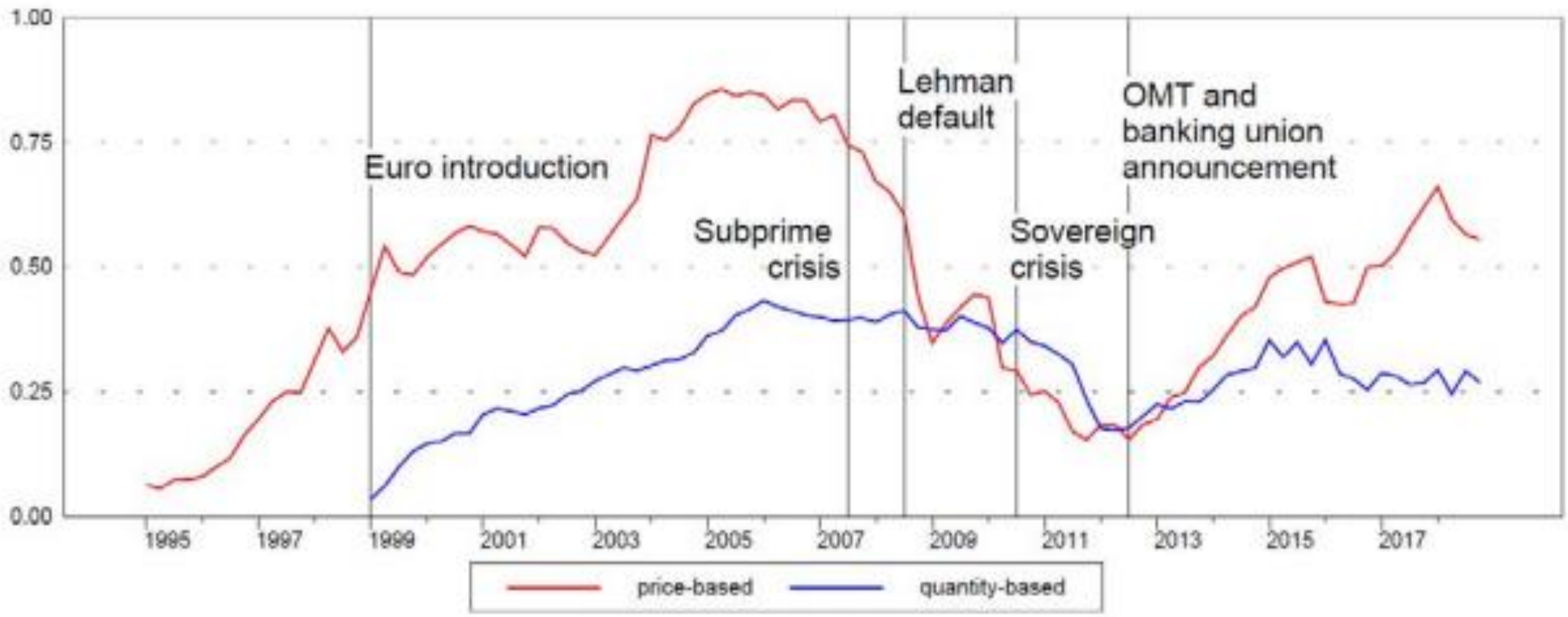
International role of the euro

"The internationalisation of the euro therefore hinges critically on the speed of integration of euro financial markets, on the willingness of the ECB not to hinder internationalisation, and on the number of participants in the monetary union (especially on UK participation) "

(Portes and Rey 1998)

Euro area financial integration progressed rapidly until crisis – then sharp decline, now still well below peak

Figure 1: The price- and the quantity-based Financial Integration Composite Indicators

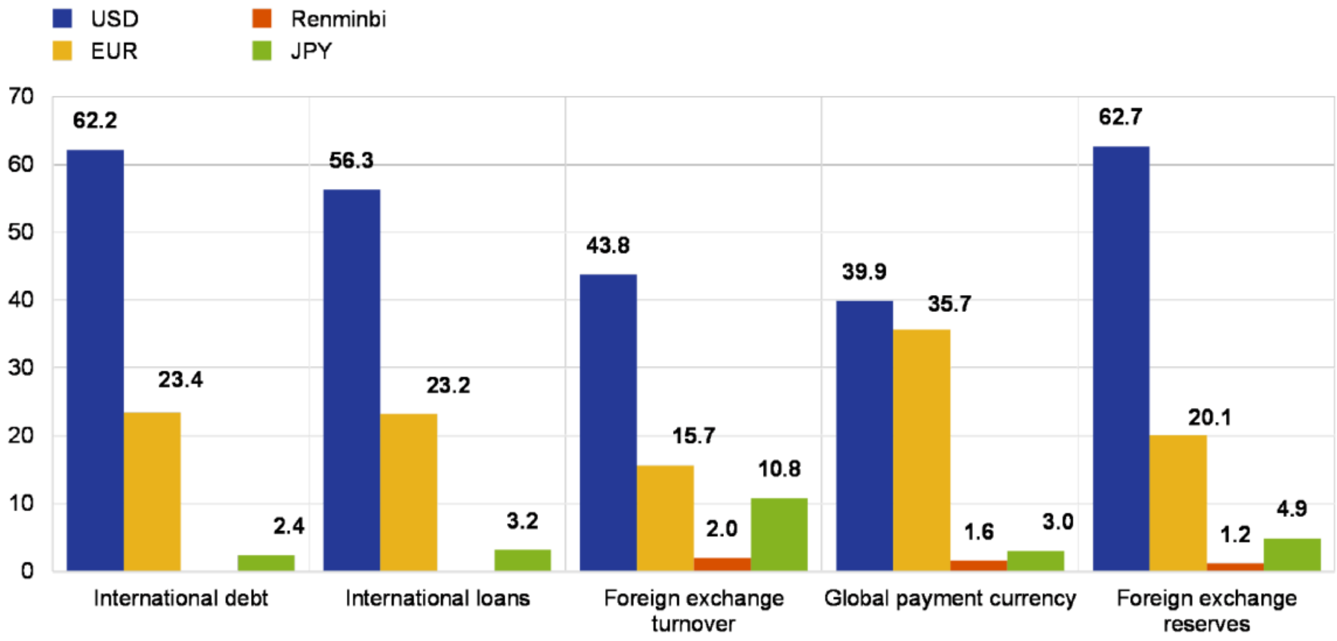


Notes: Quarterly data: Q1 1995 - Q4 2018.

Source: ECB, *Financial Integration in Europe*, May 2018, updated from: https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2319~3a5f3d0f70.en.pdf

And UK out - so euro still well behind dollar

Snapshot of the International Monetary System



Source: ECB (2018)