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The Euro Area: Creating a Stronger Economic Ecosystem*

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Introduction

As we celebrate the 20th anniversary of the euro—and as we think about the next 20 years—it is fitting that we should honor the *courage, creativity*, and *perseverance* of those who inspired this unique European project.

That spirit reminds me of a story that was once told by a great friend of Europe—President John F. Kennedy. Addressing students at UC Berkeley in 1962, he said the following:

"The great French Marshall Lyautey once asked his gardener to plant a tree. The gardener objected that the tree was slow growing and would not reach maturity for 100 years. The Marshall replied, 'In that case, there is no time to lose; plant it this afternoon!'"[1]

Twenty years ago, European countries did not just plant *one* tree, they planted an *entire forest*—**creating a new economic ecosystem known as the euro area**. The fundamental strength of that system lies in its *interconnectedness* and *diversity*—a combination that can help Europe to fully unlock its immense economic potential.

With its 19 member countries, the currency union represents the world's second-largest economy.[2] The euro is the world's second-most traded currency, making it an important reserve asset for other countries' central banks and financial institutions.

Above all, the single currency has played a central role in boosting European integration, which in turn has raised living standards across the

*Keynote address by Christine Lagarde, Managing Director, International Monetary Fund, at the 34th SUERF Colloquium & Banque de France Symposium on the occasion of the 20th anniversary of the euro, in Paris, on 28-29 March 2019.

[1] John F. Kennedy's address at the University of California at Berkeley, March 23, 1962.

[2] When measured by market-exchange rates.

continent. Real GDP per person in the euro area has increased by more than **60 percent** over the past two decades.

It is not surprising, therefore, to see strong public support for the single currency. Three in five euro area residents say that the euro is good for their country, and three-quarters say that the euro is good for the European Union. [3]

And yet, this is still a *relatively young and incomple*te ecosystem. It braved a massive storm during the global financial crisis, and another a short while later in the euro area sovereign debt crisis. These events left painful economic scars on many households and companies, sowing the seeds of economic disparity across member countries and within.

Today, one in four young people in the euro area is at risk of being in poverty, casting a dark shadow over the continent's next generation.[4] A related challenge is the rise of populist movements in several countries, calling into question the very idea of European integration.

Like any ecosystem, Europe continues to face good times and bad. After a formidable run of relatively strong growth over the last few years, economic activity in the euro area is now once again slowing, and risks are rising.

In many ways the weaker economic outlook raises an important question: **is the euro area better prepared for unexpected economic storms?**

The short answer is *yes*, the currency union is more resilient than ten years ago. But it is not resilient enough. Its banking system is *safer*, but not safe enough. Its economic well-being is *greater* overall, but the benefits of growth are not shared enough.

In other words, now is the time to strengthen this unique economic ecosystem. How? By improving financial interconnectedness in a way that truly serves all Europeans.

The Current State of the Financial System

The relative success of the Single Market in goods and services in increasing *economic* integration serves as a reminder of the failure to achieve a similar degree of *financial* integration.

There once was a vision that monetary union would serve as the foundation of a **financial union**—that just as there is a Single Market in goods and services, there would eventually be a single market in banking and non-bank finance as well.

We all recognize that finance is the *lifeblood* of commerce. At its best, it waters the seeds of innovation and facilitates the churning that every healthy ecosystem needs. At its worst, it becomes a deluge that sweeps away all that stands in its path—we saw this during the global financial crisis.

And somewhere in the middle, finance can simply be an underdeveloped irrigation system, delivering some nutrients but not enough, something that prevents the green shoots of growth from reaching their full potential.

I would put Europe's financial system in this middle category.

Unfortunately, political priorities seem to have moved to other areas. I, for one, *do not* view this as acceptable.

With the economic slowdown on everyone's minds, let me say this clearly: **now is the time to give euro area finance another big push**.

So today I will focus on the areas of financial integration where making progress is critical: the Banking Union and the Capital Markets Union

Pushing Forward on Banking Union

Let me start with the **banking union**.

Before the crisis, financial integration in the euro area saw plenty of cross-border lending, especially between banks. But it was also a time of national supervision and *neglect* of proper underwriting standards, especially if the risks were far from home.

Inevitably, what followed were sharp rises in asset prices in some countries, creating housing bubbles and fiscal bubbles. We know how that ended.

[3] Eurobarometer survey , November 2018.

[4] IMF Staff Discussion Note (2019): "Inequality and Poverty across Generations in the European Union."

When the global financial crisis hit, the large so-called "core" banks abruptly pulled their liquidity back to the perceived safety of home, precipitating credit crunches where once they had fueled credit booms. Asset prices collapsed. This retrenchment was an important contributor to the emergence of the euro area debt crisis just a few years later.

Today, cross-border lending between banks in the euro area is back at 2005 levels.

So, **should we be worried?** Yes.

Firms in some euro area countries **pay more than twice as much for credit** than comparable firms in other euro area countries. There is a similar situation for households. And this dispersion in borrowing costs has *increased* since 2009. It is the cost of **fragmentation in finance**.

Now, it is not that nothing has been done to address the problem. Far from it.

In the midst of the crisis, policymakers recognized that the institutional architecture—the plumbing system—had not held up to the storms. They realized that, to be strong and to thrive, a monetary union needs a banking union, one where risk-taking is subject *to proper* checks and balances.

Astounding progress was made in a very short amount of time. The creation of a single supervisor for banks, higher capital buffers inside banks, the introduction of a new framework for handling bank failures and crises. These new tools became critical elements of a new system of checks and balances.

The good news for taxpayers is that, as a result, they are now less likely to be on the hook for massive bank *bailouts* than a decade ago.

But that is not the whole story.

Not only is "home bias" still pervasive in European banking, as banks choose to lend and invest domestically, but banks are facing new challenges from new angles.

Higher capital at banks has meant lower returns on equity, implying a need to pursue leaner and more efficient business models.

New entrants such as **fintech firms** mean new sources of competition, bringing new pressures on bank profitability and, if not carefully managed, new incentives to ease lending standards.

In sum, we need a European banking system that can *bend* in a storm without breaking, we need a banking system that will **truly diversify risks** across the ecosystem and irrigate growth.

It is clear what is left to be done: establish **common deposit insurance**. We can find ways to resolve our legitimate national concerns and plant that vital shade-tree.

I want to emphasize that this system will be *funded by banks*, not taxpayers.

To get this done, member countries will need to agree on a mutually acceptable balance between risk-sharing and risk-reduction—between *tru*st and *accountability*. This will not be easy.

But today I *urge* euro area leaders to **reignite the discussion**, to negotiate in good faith and make the difficult compromises, to unlock the full potential of the banking union.

Unlocking the Potential of Capital Markets

In parallel, we have to pursue the essential complement to the banking union: **a thriving and integrated single European capital market**.

Just as a forest ecosystem is made more resilient by greater diversity, so Europe's financial system would be more resilient with more diversified sources of financing.

Let me give you just one data point: in the United States, the corporate bond market accounts for more than **two-fifths** of GDP, compared with only **one-tenth** in the euro area.

Former Federal Reserve Chairman Alan Greenspan once referred to capital markets as the *"spare tire"* of the financial system. [5]

[5] Alan Greenspan (1999): "Do efficient financial markets mitigate financial crises?", Remarks at the 1999 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia.

European finance also needs a spare tire.

This is why Europe has chosen to chart a course to "capital markets union."
This major endeavor, like the banking union, is ultimately about broadening the range of domestic and cross-border financing options for firms and households.

Why should people *care*?

Currently, euro area households store **40 percent** of their financial assets as bank deposits. This leaves them very exposed to the banking sector. As long as this is the case, Europe will be overly reliant on banks for savings instruments and investment financing.

Not only would an integrated capital market across the EU help companies and households reduce their reliance on banks, it would also make the ecosystem more *resilient* to shocks.

It would help achieve a more *uniform* cost of funding for firms across countries. Think of similar firms in Italy and Austria, just across the border from each other. Why should they face sharply different costs of financing when they are just a few kilometers apart?

It would also help boost people's *returns* on savings and help buffer domestic shocks to their incomes, as they include other countries' stocks and bonds in their portfolios. Think of Italian savers having an easier ability to invest in something besides Italian banks. Think of German savers desperate to earn something more than zero on their bank deposits.

There is a long way to go.

So, *how* should policymakers unlock the full potential of the capital markets?

While a number of reforms are needed to achieve more integrated European capital markets, let me highlight three key areas.

First, **transparency of information**. Capital markets are all about arms-length transactions. You buy debt or equity claims on someone *you've never met*. Here, you rely on **public information**, information you can trust. The beating heart is transparency.

Information on firms and financial instruments needs to be widely available, at low cost, based on strong audits, and presented in readily comparable ways.

A good example is the recently developed standard for securitization, which will give preferential regulatory treatment to ***simple, transparent, and standardized*** (STS) instruments. After a transition period, only these standardized securitizations will be eligible as ECB collateral. Securitization developed a bad reputation during the global financial crisis, but if properly done it can be used to broaden the investor base and increase funding options for small businesses.

Investors would also greatly benefit from more efficient **insolvency regimes**. This is my second key area. The faster and smoother the insolvency process can play out, the better. This would help free up capital that could be invested more productively elsewhere. Of course, the need for reform varies widely across Europe and insolvency procedures are deeply rooted in national traditions. Resolving a corporate insolvency in Greece takes about **nine times** longer than in Ireland, for example.

So yes, these reforms tend to be politically difficult and take time, but they are worth doing.

The same is true when it comes to my final area—taxation of **cross-border investments**. One reason financial investors may be discouraged from venturing far from home is the different rules and procedures each country has on **withholding taxes**.

Ideally, investments in other euro area countries would be treated in the same way as domestic investments. At the very least, withholding tax rules should be *simplified* and *harmonized* to encourage greater diversification in financial portfolios.

The bottom line is that planting new trees in the capital markets could help promote a Single Market in finance and transform Europe into a more vibrant and more robust economy.

It is time to *replicate* in finance what has been achieved in creating the Single Market for goods and services—a project that has raised GDP in the EU by an estimated **9 percent**. [6]

[6] Veld, J. (2019), "Quantifying the Economic Effects of the Single Market in a Structural Macromodel", *European Economy Discussion Paper*, No 094, European Commission.

Is this overly ambitious? A fully integrated EU financial market, really? Time will tell—but my money is on Europe's *courage, creativity*, and *perseverance*.

Conclusion

Let me conclude with a quote from Molière, who once said: *"The trees that are slow to grow bear the best fruit."* [7]

Some can rightfully argue that Europe has been slow to produce a fully developed financial ecosystem.

Going on 20 years, the time is ripe for the euro area to show new resolve and complete the banking and capital markets unions—so it can harvest the benefits *now* and in the future.

About the author

Christine Lagarde is the Managing Director of the International Monetary Fund. Having served her first five-year term, she was re-appointed in July 2016 for a second term. A national of France, she was previously French Finance Minister from June 2007 to July 2011, and had also served as France's Minister of State for Foreign Trade for two years. Ms. Lagarde also has had an extensive and noteworthy career as an anti-trust and labor lawyer, serving as a partner with the international law firm of Baker & McKenzie, where the partnership elected her as chairman in October 1999. She held the top post at the firm until June 2005 when she was named to her initial ministerial post in France. Ms. Lagarde has degrees from Institute of Political Sciences (IEP) and from the Law School of Paris X University, where she also lectured prior to joining Baker & McKenzie in 1981.

[7] Molière, *Le Malade Imaginaire*, Acte II, Scène V, "Les arbres tardifs sont ceux qui portent les meilleurs fruits."

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