BANQUE CENTRALE DU LUXEMBOURG

EUROSYSTEM

Beyond the Horizon of the Luxembourg Presidency:

A Central Banker's Perspective

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Narodowy Bank Polski Biannual EU Presidency Lecture

Warsaw, 27 October 2015

(Check against delivery)

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Ladies and Gentlemen,
Dear Marek,

At the outset, I would like to extend my sincere gratitude to the National Bank of Poland and in particular to Governor Belka for inviting me to give the National Bank of Poland's Biannual Presidency Lecture, which has already earned an excellent reputation and become a well-established tradition. It allows to take stock of ongoing developments in the European Union (EU) and to ponder how it could evolve in the future. I am very pleased to be given the opportunity to address such a distinguished audience here in Warsaw today.

I. Introduction

Ladies and Gentlemen,
His Royal Highness, the Grand-Duc of Luxembourg, during his state visit to Poland in May last year, introduced his speech on the occasion of the dinner offered by the President of the Republic of Poland by stating that he was touched by an invitation to Poland's Public Radio to pay tribute to Radio Luxembourg, formerly called "Luxy" by the Polish people, and that he particularly appreciated the symbolism of this gesture.

He stressed that existing ties between nations may not necessarily be material but very often had immaterial aspects. The fact that the Grand-Duchy of Luxembourg became associated with values of liberty and a certain "joie de vivre" by the Polish people was for him a source of pride.

Such reminiscence living in the memories and in the heart of people is priceless.

The paths of our two countries did not often cross directly, but we certainly have something in common, notwithstanding our different size and history. To some extent, we share a similar past in the sense that given our geographically strategic location, we too, in a more remote past, have been the target of neighbouring countries that had expansionary ambitions. But our two countries have succeeded in overcoming the greatest challenges, including historical tragedy.

The ties between Luxembourg and Poland have strengthened over time. Today, about 5,000 Polish citizens contribute to Luxembourg's multicultural landscape. I am also very glad to say that I recently appointed a Polish national who will soon join our legal department. The Central Bank of Luxembourg's staff is representing 20 different citizenships and more than 50% of its staff do not have Luxembourg citizenship.
Poland is a large country, but above all, it is a great one. It is a proud country and rightly so. Last year was a year of commemoration and celebration of several important events. You commemorated the 70th anniversary of the Warsaw Uprising. You celebrated the 15th anniversary of NATO membership, the 25th anniversary of Polish freedom and the emergence of a fully sovereign Poland, a solid parliamentary democracy and a dynamic social market economy, with an overall remarkable macroeconomic performance.

Last but not least, and this brings me to our topic of today, last year you also celebrated the 10th anniversary of Poland's accession to the EU. The fact that the current President of the European Council, Donald Tusk, is a Polish national and the President of the European Commission, Jean-Claude Juncker, is a Luxembourg national, might be considered a coincidence of European history. At any rate, it fills our two countries with a certain pride.

Allow me at this point of my speech a brief digression to share with you a few memories of my last visit to Poland, which unfortunately dates back to as far as 2001. I accompanied the then Luxembourg Prime Minister Jean-Claude Juncker on a state visit. I have fond memories of that visit, not only of the ceremony at the Tomb of the Unknown Soldier and of the very interesting formal discussions, which included an important European component, but also of a delightful lunch hosted by a Polish peasant family at their farm house in Lublin Province. Lunch was followed by a no less emotional visit to a primary and middle school, during which pupils who welcomed us very warmly showed a particular interest in the EU enlargement process and the expected accession of Poland to the EU. Throughout our stay, we were impressed by the courage and determination of the Polish people and by their eagerness to join the EU.

If anything, this experience strengthened my conviction that one of the basic tenets of the European construction is unity in diversity. It is my firm belief that the enhancement and deepening of unity has to go hand in hand with a good understanding of every current and future member State's characteristics and specificities, in all their dimensions, notably political, economic, and cultural.

To be successful, Europe must continue to be perceived by its citizens as an enriching project, economically, socially and politically, a community of basic common values in which people can prosper in peace. Without a continued broad acceptance by European citizens of the European project, the necessary future steps of integration will prove difficult, if not impossible.

In this spirit and before I get to the core of my speech, allow me to say some words about Luxembourg. After all, I just stressed the need to understand our respective historic, economic and political backgrounds.

Most of you know of Luxembourg as a financial centre, which emerged some fifty years ago. But I presume that most of you only have a vague idea of the economic development of the Grand-Duchy of Luxembourg since its independence in 1839 and up to the middle of the 20th century. So allow me to take a longer historical perspective to give you a very succinct overview of its economic development since the middle of the 19th century, an economic development, which from the middle of the 20th century, was closely co-determined by the European integration process.

Around 1850, Luxembourg was one of the poorest regions in Europe, an unproductive agricultural economy. The Luxembourg economy then experienced a takeoff, which can be described by using, on the one hand, the traditional economic concepts of supply and demand and, on the other hand, the concept of economic integration.

On the supply side, it all started with the geological discovery of a natural resource in the south of the country, namely iron ore. While the phosphorus content of the iron ore was too high to allow for the production of quality pig iron, this problem was solved by the technological import of an innovation by a British engineer, the Thomas Gilchrist process, a perfect example of cross-border technical dissemination in the 19th century.
As far as labour was concerned, labour supply was relatively elastic and this for two reasons. First, there was immigration of both a qualified labour force, such as engineers, and less qualified workers coming mainly, but not exclusively, from neighbouring countries. Second, domestic migration from the poor agricultural North to the South took place. Thus, farmers were leaving agricultural businesses to become predominantly, in the first instance, miners. Later on, through learning by doing and educational efforts, the average level of qualification of Luxembourg nationals and of the descendants of immigrants increased. Hence, Luxembourg nationals also gradually became engineers, accountants, managers etc. Let me also mention that most of the descendants of first generation immigrants acquired Luxembourg nationality. This explains why so many Luxembourgers have for example Italian family names or even

Polish ones, given the immigration of Polish citizens to Luxembourg, particularly in the interwar period.

Furthermore, the scoriae, a fallout or byproduct of the Thomas Gilchrist process, provided an excellent fertilizer for the poor agricultural soil. Thus, the industrial steel revolution boosted productivity in the agricultural sector. The large industrial investments that were needed were financed with capital that mainly came from Belgium and Germany.

There was also an institutional or sovereign dimension in the sense that a law voted by Parliament conditioned the granting of concessions of iron ore exploitation to an obligation of on-site transformation of iron ore to a final product, thus laying the foundations for the development of a value added chain on Luxembourg territory.

On the demand side, there was no significant demand in Luxembourg for the products of the steel industry, which, moreover, was characterized by economies of scale. However, at that time, Luxembourg was a member of the Zollverein, a German customs union. The Zollverein offered a large free-trade area for steel made in Luxembourg and facilitated the supply of coal, a key input to steel production. Without such economic integration, the steel industry would not have been at the origin of the economic upswing and, later on, the engine of growth of the Luxembourg economy, and this for more than a century. As a Luxembourg economist[1] once said: “Just as Egypt is a gift of the Nile, Luxembourg is a gift of iron”.

Some fifty years ago, in the 1960s, the steel industry, directly or indirectly, accounted for nearly 50% of Luxembourg’s GDP; it was the most important employer and constituted the key source of tax revenue for the Luxembourg State. But, as history consistently shows, there is no sustained growth without structural change and without shocks.

[1] Carlo Hemmer

In the aftermath of the 1974 oil shock, the steel industry throughout Europe suffered a structural crisis of unprecedented magnitude. Luxembourg, depending very much on the exports of steel, was very seriously impacted. It was confronted with an economic crisis of national dimension with tremendous potential consequences in macroeconomic terms, and which could have entailed the country's downfall.

But, around that time, an exceptional and lucky historical coincidence occurred in a country that in the 1960s only had around half a dozen commercial banks, a number that was largely sufficient to cover the needs of the small domestic market. When the steel industry declined, Luxembourg experienced the birth and development of a financial centre, without there being any direct causal relationship between the decline of the steel production and the expansion of financial services. The initial development and the expansion of the financial sector had multiple causes and most of these were of an external origin.

This said, let me take a step backwards to the period after World War I. After World War I, the German Zollverein was dissolved and Luxembourg had to look for a new economic partnership. In a referendum organized in 1919, a large majority of the Luxembourg population expressed a preference to enter into an economic union with France. However, such an interest was not reciprocal and Luxembourg finally turned to Belgium, which led to the establishment of the Belgo-Luxembourg Economic Union. The economic union, mainly based on a customs union, became effective in 1922. It included elements of monetary cooperation, which led to the establishment of a monetary association between Belgium and Luxembourg in 1935. The monetary association was highly asymmetric. Luxembourg was not granted a central bank and was not directly involved in monetary policy decisions. In a nutshell, it had no monetary sovereignty.

With the introduction of the euro, the monetary association was dissolved. As requested by the Maastricht Treaty, Luxembourg established a national central bank in June 1998, before the introduction of the euro.

This very succinct overview shows that economic and political integration have throughout Luxembourg's history been a key factor for the development of the Luxembourg economy, a very small open economy, which is export-led and partly import-driven.

I mentioned the Zollverein, followed by the creation of the Belgo-Luxembourg Economic Union[2] and monetary association. That process was followed by European integration, starting with the European Coal and Steel Community (ECSC), and followed later by the creation of the European Economic Union and the European Union. The symbiotic relationship with Europe has served the country well and the pro-European public opinion in Luxembourg towards Europe has remained unscathed despite the challenges the country, the European Union, and, more specifically and recently, the euro area have been facing over the years, especially the global financial crisis that started unfolding some eight years ago.

This brings me to the Luxembourg Presidency's programme, which is ambitious and based on seven pillars:

- Stimulating investment to boost growth and employment,
- Deepening the European Union's social dimension,
- Managing migration, combining freedom, justice and security,
- Revitalising the single market by focusing on its digital dimension,
- Placing European competitiveness in a global and transparent framework,
- Promoting sustainable development,
- Strengthening the EU's presence on the global stage.

[2] There also was the Benelux Union signed in 1949 between Belgium, the Netherlands and Luxembourg.

I hope you do not expect me to cover all these items. Besides, since an EU Presidency is a government-driven process, and since central banks are independent off political processes, I will try to confine my remarks to topics that are of a more direct interest to central banks. I will also seize this opportunity to share a few personal thoughts on how the EMU's governance could be further improved over the years.
These reflections will be structured in two parts.

In the first part, I will briefly highlight the ongoing challenges for the single monetary policy, and touch upon the macroeconomic outlook for the euro area.
I will then take stock of key measures that have been taken to strengthen European economic governance, and point out some possible improvements and avenues that could be explored to further enhance the EMU's framework over the medium term, before concluding.

II. The global financial crisis and ongoing challenges from a monetary policy perspective

The global financial crisis that started to unfold in 2007, by any historical standard, gave rise to very challenging economic and financial conditions. Between 2007 and 2013, facing elevated pressures in several financial market segments as well as contracting economic activity, the ECB's Governing Council adopted forceful and timely standard and non-standard measures. Against the backdrop of the wealth of the Eurosystem measures taken in response to the financial crisis, I will focus on the current euro area challenges from a monetary policy perspective and the measures taken by the Eurosystem since 2014.

An overview of the measures taken in response to the financial crisis covering, among others, liquidity management actions, changes to the collateral framework, supplementary longer-term refinancing operations, asset purchase programmes, and forward guidance, will be included as an annexe to the written version of this speech.
Importantly, it is because of the forceful measures taken between 2007 and 2013 that the ECB's Governing Council consistently provided an anchor of stability and confidence throughout the financial and sovereign debt crisis.
As a matter of fact, despite the severe tensions during the financial and sovereign debt crisis and the resulting volatility in economic activity and headline inflation,[3] inflation expectations remained firmly anchored at levels consistent with the Governing Council's aim of keeping inflation rates below, but close to, 2% over the medium term.

[3] While annual HICP inflation stood at 3.3% in 2008, the annual rate of change in the HICP declined to 0.3% in 2009. On a monthly basis, annual HICP inflation varied between -0.6% in July 2009 and 4.0% in June and July 2008.
Real GDP growth dropped from 3.2% in 2006 to -4.5% in 2009. While the euro area returned to positive growth in 2010 and 2011 (2.1% and 1.6%, respectively), the euro area economy contracted by 0.8% and 0.3% in 2012 and 2013, respectively.

Throughout 2014, however, additional contingencies materialized, with risks extending to a worsening of the medium-term outlook for inflation and a loosening in the anchoring of inflation expectations. While standing at elevated levels above 2% in 2011 and 2012, annual HICP inflation declined throughout 2013[4] and - in a context of already low inflationary pressures - continued its downward trend in 2014.

Moreover, survey and market-based inflation expectations reacted to low actual inflation. While the impact focused on short-term inflation expectations, from mid-2014 medium to long-term inflation expectations also tended to decline.

The risk of inflation remaining low for too long a period of time thus became a key concern.

In the course of 2014, therefore, the Governing Council lowered key policy interest rates further and introduced a negative interest rate on the deposit facility in June 2014 (-0.1%, further lowered to -0.2% in September 2014). Since September 2014, the main refinancing rate stands at 0.05%.

With key policy interest rates in the vicinity of a lower bound, the Governing Council adopted further non-standard monetary policy measures in 2014, not only in order to address impairments in the transmission of monetary policy, but also with a view to initiating a monetary accommodation beyond what could be achieved through reductions in policy interest rates, thereby supporting the anchoring of medium to longer-term inflation expectations in line with the Governing Council's price stability objective.

In June 2014, the Governing Council announced a series of targeted longer-term refinancing operations (so-called "TLTROs"). TLTROs provide long-term funding over a

[4] HICP inflation declined from 2.2% in December 2012 to 0.8% 12 months later. HICP inflation dropped – and remained since – below 1% in October 2013.

period of up to 4 years. The exact borrowing terms depend on the volume of a borrower's lending to the real economy (relative to a benchmark that is specific to each credit institution). By combining low long-term refinancing rates and positive incentives to lend, TLTROs aim at enhancing loan supply and lowering lending rates. Unlike the longer-term refinancing operations introduced earlier in response to the financial crisis, TLTROs are specifically designed to provide incentives for lending to the real economy, one of the key factors holding back the recovery.
Then, in September 2014, the Governing Council announced an asset-backed securities purchase programme ("ABSPP") and a new covered bond purchase programme ("CBPP3").

The Governing Council stated that it expected these two asset purchase programmes to last for at least two years. Both programmes are tailored to the financial structure of the euro area economy. The covered bond market represents a primary source of financing for euro area banks and the link to the underlying loans is fairly close. ABS interest rate spreads, too, are closely linked to the lending rates banks apply on the underlying loans.

Therefore, both purchase programmes complement the TLTROs in strengthening the transmission of monetary policy to the borrowing conditions of the non-financial private sector in the euro area and in supporting credit conditions for businesses and households in the euro area.

At the end of 2014, the Governing Council communicated its intention to increase the Eurosystem's balance sheet towards the level that existed at the beginning of 2012 in order to provide a sufficient degree of monetary stimulus to raise the inflation rate to levels below, but close to, 2%.

Thus, in early 2015, it conducted a thorough reassessment of the outlook for price developments and of the monetary stimulus achieved. Back then, it concluded that the medium-term inflation outlook had weakened. While the monetary policy measures adopted since June 2014 permitted a satisfactory pass-through of the liquidity injected to private sector borrowing costs, the prevailing degree of monetary accommodation was not sufficient to adequately address heightened risks of too prolonged a period of low inflation.

Against this background, the Governing Council decided to expand asset purchases to encompass euro-denominated investment grade securities issued by euro area governments as well as agencies and European institutions (the so-called Public Sector Purchase Programme, “PSPP”). The combined monthly purchases of public and private sector assets under all three pillars, together called the Expanded Asset Purchase Programme (i.e. the ABSPP, the CBPP3 and the PSPP), amount to €60 billion. They are intended to run until the end of September 2016, or beyond if necessary, and, in any case, until we see a sustained adjustment in the path of inflation that is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term.
Given the various channels through which each of the monetary policy measures taken since June 2014 operate, and due to the well-known lags of monetary transmission and the uncertainty with regard to the counterfactual, it is too early, at the current juncture, for a final assessment of the final impacts of these measures.

There is, however, ample evidence that the monetary policy measures in place since June 2014 have been conducive to an easing in borrowing conditions and have supported credit flows in the euro area. Since last year, interest rates for bank loans declined by much more than the concomitant reduction in policy rates.[5]

[5] Between May 2014 and August 2015, the composite cost-of-borrowing indicator for euro area non-financial corporations and households declined by 75 basis points and 67 basis points, respectively. Over the same period, policy interest rates declined by 20 basis points (main refinancing operations and deposit facility) and 45 basis points (marginal lending facility).

In the October 2015 Bank Lending Survey, euro area banks reported a stronger than expected net easing of credit standards on loans to businesses in the third quarter of 2015. Moreover, net demand for loans to businesses and for housing loans strengthened. Regarding euro area banks' access to retail and wholesale funding, the October 2015 Bank Lending Survey suggests improved access to funding for all main market instruments (retail deposit funding, however, deteriorated slightly). Banks continue to report that the additional liquidity generated by the expanded asset purchase programme is being used for lending. Finally, banks report that the expanded asset purchase programme has had a net easing impact on credit standards, in particular for loans to businesses.

With regard now to inflation and growth, the September 2015 ECB staff macroeconomic projections show a more mixed result. They indicate a continued, though somewhat weaker, recovery and a slower increase in inflation rates compared with earlier projections.[6] More recently, renewed downside risks have emerged to the outlook for growth and inflation. At the same time, the 2015Q3 and the 2015Q4 Surveys of professional forecasters[7] suggest that the 2014/2015 package of measures led to a stabilisation of longer-term inflation expectations.

It is important to underline that these projections on inflation and on output are based on, and are conditional on, a full implementation of the Expanded Asset Purchase Programme announced in January and on the full implementation of the credit easing measures decided in the course of 2014. This monetary policy stance is considered

[6] The September 2015 ECB staff (June 2015 Eurosystem) macroeconomic projections foresee annual HICP inflation at 0.1% (0.3%) in 2015, 1.1% (1.5%) in 2016 and 1.7% (1.8%) in 2017. Compared with the June 2015 BMPE, the outlook for HICP inflation has been revised down largely due to lower oil prices. The September 2015 ECB staff (June 2015 Eurosystem) macroeconomic projections foresee real GDP growing by 1.4% (1.5%) in 2015, by 1.7% (1.9%) in 2016 and by 1.8% (2.0%) in 2017. The slightly weaker outlook for activity than the June 2015 BMPE largely reflects a less favourable external environment.

[7] According to the 2015Q3 and the 2015Q4 Surveys of professional forecasters, longer-term inflation expectations stood at 1.9% (up from 1.8% according to the 2014Q4, 2015Q1 and 2015Q2 survey rounds).

essential for a continued recovery and a convergence of inflation towards our price stability objective. It has to be stressed that these projections were also based on a set of technical assumptions (e.g. in relation to international factors, including exchange rates, oil price, and commodity prices). To the extent that these factors could change, and could possibly worsen, thereby entailing increased downside risks, the current monetary policy stance would have to be revisited.

In light of the renewed risks that have emerged on the back of recent developments in global economic, financial and currency markets, the Governing Council will continue to monitor very closely the risks to the outlook for price developments over the medium term. It is ready to use all the instruments available in its mandate to act, if so warranted.

While our monetary policy measures have contributed to the euro area recovery and to a gradual improvement in the inflation outlook for price stability, monetary policy is not a panacea and not the only game in town.

Our measures should be supported by action in other policy domains to support economic recovery and to ensure debt sustainability. Let me mention two of them: structural reforms and fiscal policy.

First, a continuation of structural reforms is necessary and they should be seen beyond the confines of national economies. They could, inter alia, increase the growth potential of the euro area and make it more resistant to shocks. In this context, one should keep in mind that already before the crisis the level of unemployment was too high and the growth of potential output too low. One of the most important economic challenges, next to a greater economic convergence, is an increase in potential growth with an increase in productivity; this should also be seen against the background of demographic challenges. I have elaborated on this point in a speech I recently gave at the EurofiFinancial Forum.

Second, while having to stay fully compliant with the EU fiscal rules of the Stability and Growth Pact, fiscal policy can also contribute to supporting the economic recovery, particularly through growth-enhancing public investments, material and immaterial, which have a demand and a supply effect. It also seems that in some countries, including Luxembourg, there is scope for tax reforms that could both enhance efficiency and reduce inequality, while being revenue neutral.

Furthermore, against the background of weak investment, the *Investment Plan for Europe* – also referred to as *Juncker Plan* -, is a welcome initiative and a priority of the Luxembourg Presidency. It aims to unlock additional investment of at least €315 billion over the next three years by addressing market gaps and by mobilising private capital. Beyond the immediate objective to boost investment, the *Investment Plan for Europe* strives to improve long-term competitiveness, human capital and physical infrastructure.
Let me now come to the governance of the Economic and Monetary Union (EMU).

III. EMU governance: progress achieved and room for further improvement

The Economic and Monetary Union (EMU) involves the coordination of economic and fiscal policies, a single monetary policy and a single currency, the euro. While the single monetary policy and the single currency were established with the inception of the euro ("monetary union"), the financial crisis revealed a clear need for a strengthening of the coordination of economic and fiscal policies (the "economic pillar" of the union). And, indeed, we have witnessed significant progress, notably with regard to the Economic and Governance framework, the Banking Union, the strengthening of the macro-prudential framework, and the establishment of financial backstops. I will touch briefly on those domains.

Economic and fiscal governance

Following the financial and sovereign debt crisis, a number of important initiatives were taken with a view to avoiding unsustainable developments in individual countries that were jeopardising the smooth functioning of the Economic and Monetary Union. The preventive and corrective arms of the Stability and Growth Pact have been strengthened and complemented by, among others, a macroeconomic monitoring exercise to address macroeconomic imbalances ("Macroeconomic Imbalance Procedure") before they could become systemic and spill over to other Member States.
The new rules introduced by a set of legislative initiatives, known as "Six Pack" [effective in 2011] and "Two Pack" [effective in 2013] and the Treaty on Stability, Coordination and Governance in Economic and Monetary Union, with its Fiscal Compact [also effective in 2013], undoubtedly brought about important changes to the Stability and Growth Pact like the operationalization of the debt rule, a stronger focus on expenditures, as well as automatic correction mechanisms that are to be monitored and assessed by national bodies that have to be independent. At the same time, the new framework allows for more flexibility, depending in particular on a Member State's underlying budgetary position over the medium term.

The new rules aim to better prevent deviations from set budgetary objectives and to enforce potential sanctions more effectively. Under the current framework, surveillance has been extended to macroeconomic policies through the Macroeconomic Imbalance Procedure and can even be strengthened for euro area Member States with high fiscal deficits or public debt, or facing challenges pertaining to financial stability. Annual assessments are conducted in the context of the "European Semester".

However, despite the substantial progress that has been made so far, there is room for further improvement, both in terms of form and substance.

First, the economic and fiscal governance framework has become very complex, to say the least. Clarification and simplification of that framework could lower the risk of misinterpretations and misperceptions.

Second, for a rule-based framework to be credible it is imperative to apply the rules effectively. Recent reforms endowed the Stability and Growth Pact with some degree of flexibility.[8] However, when interpreted too widely, the flexibility of the Stability and Growth Pact could increase risks related to debt sustainability.

The Banking Union

The Banking Union, based on three pillars (i.e. the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the single Deposit Guarantee Scheme) constitutes a major step in addressing some of the major weaknesses uncovered by the crisis.

Since 4 November 2014, the ECB is at the helm of the **Single Supervisory Mechanism** (SSM), which will help harmonize banking standards across the euro area and help reduce the fragmentation, along national lines, of the banking landscape.
One might argue that the Banking Union is a corroboration of Jean Monnet's famous statement, according to which "Europe will be forged in crisis and will be the sum of the solutions adopted for those crises".[9] Indeed, after the financial crisis and, even more, after the sovereign debt crisis in the euro area, there was an acute awareness of the incompleteness of the Economic and Monetary Union. All of a sudden, European

[8] See also the Communication "*Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*" issued by the European Commission in January 2015.
[9] Jean Monnet (1976), Memories, Paris Fayard.

integration received a boost, this time with the inception of a banking union, which took shape very rapidly. The work on the single rulebook started as early as 2009, and, by the end of 2013, there was the Capital Requirement Regulation (CRR), the Capital Requirement Directive (CRD IV) and the founding act of the SSM regulation.[10]

The establishment of the SSM, which has been a major undertaking, not only in terms of staff and resources, was well managed by the ECB. In full separation between monetary policy and banking supervision, it ensures independent banking supervision of the highest quality, without interference of other, non-prudential, considerations. Significant progress also has been achieved with regard to the establishment of a framework for the resolution and restructuring of banks, the second pillar of the Banking Union.

The **Single Resolution Mechanism** (SRM), established by way of an EU Regulation that entered into force in August 2014, introduces a European framework to ensure the orderly resolution of banks covered by the SSM. Within this framework, a resolution procedure is triggered by the ECB which, in its capacity as supervisor, expresses an opinion on a bank's solvency. The Single Resolution Board, which will be fully operational as from 1st of January 2016, is at the core of the SRM. It is responsible for preparing and implementing the effective resolution of insolvent banks, especially significant and cross-border banks, in cooperation with the national resolution authorities.

The EU Bank Recovery and Resolution Directive (BRRD), adopted in May 2014, introduced a single rulebook for the resolution of banks. With the transposition of this directive into the national laws of the Member States, national authorities are endowed with the tools required to restructure or unwind banks in a timely and orderly manner, minimizing the costs of bank failures. Another fundamental measure introduced by the

[10] Danièle Nouy, Chair of the Supervisory Board of the SSM. "The banking union, one year on", Center for European Reform, London, 21 October 2015.

BRRD is the “bail-in” tool. In future resolutions and restructurings of banks, shareholders and creditors will have to contribute to the absorption of losses and capital recovery of the failed banks. In addition, banks themselves will finance the national resolution funds introduced by the BRRD. From 2016, the Single Resolution Fund, which will be built up over a period of eight years, will replace these national funds in Member States participating in the SSM and the SRM.

Further progress is required in relation to the third pillar of the Banking Union, a single Deposit Guarantee Scheme. Admittedly, a new EU Directive on deposit guarantee schemes, which aims to address the current weaknesses by ensuring a uniform level of protection of depositors throughout the European Union and to eliminate market distortions, was adopted in April 2014. Nonetheless, an effective crisis management framework should include a credible single deposit guarantee scheme. In light of the pan-European solutions that have been adopted for the SSM and the SRM, it would be consistent to take a similar approach for the third pillar of the Banking Union. As announced some days ago, the Commission will make a legislative proposal on the first steps towards a common *European Deposit Insurance Scheme* by the end of this year.

Strengthening of the macro-prudential framework

While it is important to supervise individual institutions, it is equally important to safeguard the stability of financial systems as a whole by containing systemic risks.
Back in 2010, the European Parliament and the European Council agreed on the EU regulations establishing the European Systemic Risk Board (ESRB), which is responsible for the macro-prudential oversight of the financial system within the European Union. Since then, the macro-prudential framework in Europe has been strengthened. The CRD IV and CRR, for instance, introduce macro-prudential instruments that can be applied by designated national macro-prudential authorities. In

each Member State, National Central Banks play a key role in macro-prudential oversight. In this regard, but also more generally, their independence is key.

The SSM Regulation requires that national authorities notify the ECB when applying macro-prudential measures embedded in the CRD IV and CRR and take into consideration the ECB's views if the latter objects to such measures. The SSM Regulation also allows the ECB, in cooperation with the national authorities, to adopt, if deemed necessary, higher buffer requirements or take stricter measures than those adopted by the national authorities.

Despite the progress already made, further advances in the macro-prudential framework are necessary.

First, the macro-prudential framework embedded in the CRD IV and CRR applies to credit institutions only, leaving aside less-regulated institutions. While the optimal degree of regulation imposed on less-regulated entities remains the subject of intense discussions, more regulation is justified where such entities carry out activities that are close substitutes to banking intermediation (in particular institutions lending to households). Macro-prudential authorities should also assess exposures that exist between credit institutions and less regulated credit institutions.

Second, under the current framework, macro-prudential instruments not included in the CRD IV and the CRR, such as loan-to-value and loan-to-income ratios, remain in the exclusive remit of national authorities. Discretionary power of national authorities can potentially lead to unequal governance structures and/or an unequal application of macro-prudential rules or instruments.

Having said that, it has to be recognized that macro-prudential frameworks and policies are still in their infancy. The deeper nature of systemic instability remains to be fully understood. The development of tools to detect and assess risk is work in progress. It remains the subject of comprehensive research, both in central banks and academia. In order to deepen, inter alia, our understanding of macro-prudential tools, the Banque centrale du Luxembourg recently signed a cooperation agreement with the Toulouse School of Economics (TSE), which is led by professor Jean Tirole who was awarded the Nobel prize in economics in 2014.

Financial backstops

Finally, let me briefly mention another major contribution to the strengthening of the Economic and Monetary Union following the financial crisis, namely the establishment of *financial backstops* for the euro area.

The European Financial Stability Facility (EFSF) was introduced as a temporary mechanism in 2010. Two years later, the European Stability Mechanism (ESM), a permanent mechanism that may funnel, under effective strict conditionality, financial assistance to euro area Member States experiencing financing difficulties was established under an intergovernmental agreement. The EFSF and the ESM, which together have a combined lending capacity of €700 billion have, so far, disbursed about €250 billion of financial assistance to five Member States. In December 2014, the ESM Board adopted the Direct Recapitalization Instrument (DRI), which provides the ESM with the capacity to directly recapitalize banks in the euro area under certain conditions, thereby contributing to severing the link between banks and public finances.

IV. The way forward: a longer-term view

Let me now briefly highlight two areas that could be of overriding importance for the more longer-term future design and functioning of the European Union and the euro area, i.e. the capital markets union and the way towards a type of "fiscal union".

The Capital Markets Union

The Capital Markets Union (CMU), which is high on the agenda of the Luxembourg Presidency, is a major undertaking, a genuine European-wide project.

The CMU is welcomed by the Eurosystem, which delivered its opinion several months ago. On 30 September 2015, the European Commission issued its *Action Plan on Building a Capital Markets Union.*[11] It aims to put in place the building blocks of a well regulated and fully functioning CMU in the EU by 2019. While the details of the design of the CMU remain to be defined, given the complexity of the undertaking and the potentially far-reaching implications, a thorough stock-taking of the issues at stake should be followed by prioritized and targeted outcomes.

The CMU is intended to deepen the integration of capital markets in the European Union. Deeper integration would foster the efficiency of capital markets by providing businesses with access to a wide range of sources of capital from all over the European Union and by offering investors and savers additional investment opportunities, thereby enhancing economic growth and job creation.

In this context, let me recall that the Eurosystem is particularly supportive of measures aimed at reviving securitization. It welcomed the Draft EU Regulation introducing criteria

[11] Building a Capital Markets Union - Eurosystem contribution to the European Commission's Green Paper.

for simpler, more transparent and standardized Asset Backed Securities (ABS), which allows such securities to be acceptable as collateral and to be purchased by the Eurosystem.

Financing through the markets and financing through banks should not be seen as a trade-off, but as substitutes. Banks will remain key players in capital markets, and will continue to play a major role in credit intermediation through their role in funding and provision of information, especially to SME's. Europe needs a network of strong and efficient retail banks offering good service in a competitive context. Europe also needs strong players in financial markets, not in the sense of national champions, but in the sense of genuine European financial actors.

To bring about its expected benefits, the CMU should foster and result in a high level of financial integration in capital markets across the European Union, based on an adequate legal and regulatory framework. This framework should be cast wider in order to cover also less regulated and more opaque activities, such as shadow banking.
CMU could imply, inter alia, more ambitious steps towards a greater convergence of:

- Bankruptcy laws,
- Company laws, and
- Taxation of financial products, including reflections on how to reduce or even eliminate the current taxation bias in favour of debt financing and against equity. Although there are complaints about the over-reliance on debt and the fact that leveraging is too high, debt is favoured over equity through taxation. It seems to me that there is some inconsistency here.

Towards a type of "Fiscal Union"

Imperfect labour mobility as well as price and wage rigidities within the euro area do not fulfil the conditions of an optimal currency area. Against this background, Heads of

Governments established facilities aimed at increasing economic and social convergence via (limited) fiscal transfers. Some progress has also been made in the field of tax harmonisation and tax transparency; other initiatives are under preparation. Absent the determination among policy makers to share sovereignty in the fiscal domain, the economic and fiscal governance of EMU aimed to foster a high degree of coordination between national economic policies. Notwithstanding the various efforts undertaken since the financial crisis, over the long-term, economic and fiscal governance in the euro area could benefit from being strengthened more fundamentally.

The Five Presidents' Report, for instance, concludes that *"all mature Monetary Unions have put in place a common macroeconomic stabilisation function to better deal with shocks that cannot be managed at the national level alone"*.

This Report provides a comprehensive study of the key elements of such a potential common macroeconomic stabilisation function for the euro area, including – among others – a (sufficiently large) central fiscal capacity, an EMU Treasury, the issuance of bonds guaranteed by all euro area Member States and a system of transfers (with gradually increasing coverage) conditional on fiscal discipline and reform processes owned by the beneficiaries. Such a move towards a type of "fiscal union" would certainly raise complex economic and legal questions and would have far-reaching implications. Accordingly, the exact design of an effective fiscal stabilisation mechanism for the euro area will and should continue to be the subject of extensive, yet inspiring, analysis and of constructive discussions. Such a reform process requires the acceptance of citizens and must be appropriated by national actors. Reforms without citizens' acceptance and without ownership cannot succeed. Participatory processes and good communication are key. It would also be an illusion to think that more solidarity, notably through more transfers, could be agreed upon without strengthened institutionalized discipline, inter alia in the fiscal field, as well as without any additional structural reforms.[12]

V. Conclusion

Ladies and Gentlemen,
Let me conclude.

From the day the six founding members of the ECSC decided to establish a common market for coal and steel to the day eleven countries adopted a single currency, nearly 50 years went by. Starting with selective sectoral integration, Europe gradually moved to an economic and monetary integration, a truly inspiring achievement. Meanwhile, the euro has become the currency of almost 340 million people residing in 19 European countries.

Concerning the adoption by Poland of the euro, the future will tell us when Poland will join the euro area. Let me only add on a very personal note that when that happens, I will not be discontent.

The global financial crisis has shown the imperative need to bring EMU to the next level by making it more resilient, more integrated and more inclusive. The crisis revealed the inherent weaknesses of EU's economic governance, both in terms of crisis prevention and crisis management, and significantly accelerated the necessary reform process.

Ladies and Gentlemen, the European institutional architecture will need to be enhanced further. My conviction is that Europe needs more, not less, integration, more, not less, solidarity and more, not less, mutually shared discipline. We should always keep in mind that the European project emanated after World War II. It is a project of trust and

[12] I elaborated on the latter point in my opening remarks at the October 2015 Eurofi conference in Luxembourg.

peace, and peace should never be taken for granted, as exemplified by recurrent geopolitical turbulences, including close to our borders, and resurgent nationalism.
However, enhanced solidarity and sharing of sovereignty will only be possible if Member States that decided to become part of a community of shared destiny show rigor and abide by the rules they established and will have to establish in the future.

The current dramatic refugee and immigrant crisis, which is also a humanitarian one, furthermore highlights the need not only for short term coordination action but also the need for a longer term institutional response.

Thank you for your attention.

Annexe

The recent financial crisis unfolded in three main episodes:

1. **Increased delinquency and foreclosure rates for US sub-prime mortgages in the second half of 2007** led to acute pressures and elevated volatility in short-term funding markets. The Eurosystem swiftly reacted by conducting supplementary longer-term refinancing operations, taking joint action with the Federal Reserve by offering US dollar funding to Eurosystem counterparties and by "frontloading" the liquidity provision to the banking sector within reserve maintenance periods.

2. **Following the collapse of the US financial institution Lehman Brothers in mid-September 2008 fin**ancial tensions intensified considerably across all money market segments and maturities and increasingly spread to the real economy throughout the world. In a coordinated move, the ECB and six other major central banks announced reductions in their policy interest rates in October 2008.[13] In addition, with a view to ensure the continued ability of banks to refinance themselves and to support credit flows above and beyond what could be achieved through reductions in key interest rates, the Eurosystem took further liquidity management measures. The measures were tailored to the financial structure of the euro area economy and the specific circumstances of the crisis. They focused on a significantly increased liquidity provision to euro area banks as they are the primary source of financing for the real economy in the euro area. In particular, a fixed rate tender procedure with full allotment was adopted for main refinancing operations and longer-term refinancing operations. In addition, the Eurosystem conducted supplementary longer-term refinancing operations (maturities of six months and 1 year) with a view to enhance the provision of longer-term refinancing and temporarily widened the set of eligible collateral accepted in refinancing operations. As part of its "enhanced credit support", in

[13] On October 8, 2008, the Governing Council decided to lower all three policy interest rates by 50 basis points (minimum bid rate on the main refinancing operations lowered to 3.75%; interest rate on the deposit facility rate lowered to 2.75%; interest rate on the marginal lending facility lowered to 4.75%).

2009, the Eurosystem also launched a programme of outright purchases, for an amount of €60 billion, in the covered bond market, a very important market in Europe and a primary source of financing for banks.

3. As a result of these enhanced credit support measures - in combination with the Governing Council's considerable reduction in key policy rates[14] - banks generally continued to have broad access to euro liquidity and money market interest rates declined significantly. With financial market conditions having improved in the course of 2009 and early 2010, the Governing Council gradually scaled back some of the non-standard measures while continuing to provide liquidity support to the banking system at very favourable conditions with a view to facilitate the provision of credit.

4. Another episode of the crisis started to unfold **in May 2010 when market concerns about the sustainability of public finances in some euro area countries grew** in view of rapidly rising government debt-to-GDP ratios and increasing contingent liabilities. Bond markets in these euro area countries became severely dysfunctional. Given the importance of government bond markets for the transmission of monetary policy, there was a risk of serious impairments in the ability of banks to provide credit to the real economy. Against this background, in May 2010, the Governing Council launched the Securities Markets Programme (SMP)[15] with the aim to ensure depth and liquidity in dysfunctional market segments and to safeguard the proper functioning of the monetary policy transmission mechanism. Since the aim of the programme was not to inject additional liquidity into the banking system, until June 2014, SMP interventions were fully sterilised.

[14] In the context of subdued inflationary pressures and a severe downturn in the euro area economy, between October 2008 and May 2009, the Governing Council lowered the main refinancing rate from 4.25% to 1%.
[15] In addition, the Governing Council reintroduced some of the non-standard measures phased out earlier (e.g. reactivation of temporary liquidity swap lines with the Federal Reserve System and a new six-month refinancing operation).

5. Having temporarily improved after the announcement of the SMP (and following the commitments taken by some euro area governments to ensure the sustainability of public finances), conditions in several financial market segments in the euro area deteriorated significantly in the second half of 2011. The Governing Council swiftly took bold measures encompassing two longer term refinancing operations (with a maturity of up to 3 years), US dollar liquidity providing operations and liquidity swap operations (coordinated action with other central banks). The two 3-year longer-term refinancing operations announced conducted in December 2011 and February 2012 led to a considerable increase in excess liquidity, thereby contributing to a significant easing of financing strains. In addition, the Governing Council announced a new covered bond purchase programme, for an intended nominal amount of €40 billion (November 2011), co-announced coordinated central bank action to enhance the capacity to provide liquidity support to the global financial system (November 2011) and introduced comprehensive measures to increase collateral availability (December 2011).

6. The sovereign debt crisis continued to have an adverse impact on economic confidence and financing conditions in 2012, also reflecting a perceived lack of determination of governments to tackle the root causes. In mid-2012, funding stress in the banking sector was aggravated by a severe malfunctioning in some euro area sovereign bond markets, partly related to unfounded fears of reversibility of the euro. Very high risk premia in some government bonds and financial fragmentation hindered the effective working of monetary policy. With a view to safeguard monetary policy transmission, the singleness of monetary policy and integrity of the euro area, in August/September 2012, the Governing Council announced the concept of outright monetary transactions in secondary sovereign bond markets in accordance with the monetary policy mandate ("OMTs"). OMTs are subject to strict effective conditionality attached to an appropriate EFSF/ESM programme as a necessary condition. While OMTs are not subject to ex-ante quantitative limits, liquidity injected through OMTs will be

fully sterilised. While OMTs have not been activated to date, their mere announcement contributed to addressing risk premia related to self-fulfilling expectations of highly disruptive scenarios. While OMTs themselves cannot remove the root causes of severe impairments, strict effective conditionality ensures that root causes are tackled (a mechanism much stronger than in the case of the SMP which was terminated in September 2012).

7. While financial fragmentation moderated in 2013, inflationary pressures receded. The annual rate of inflation declined from 2.7%/2.5% in 2011/2012 to 1.3% in 2013, on average. With a view to ensure price stability in the context of low underlying price pressures and to foster the economic recovery, the Governing Council lowered policy rates further (from 1.5% in July 2011 to 0.25% in November 2013). In the first half of 2013, also reflecting spillovers from developments outside the euro area, both the level and the volatility of euro money market interest rates increased, thereby reducing the monetary accommodation introduced by the Governing Council. In order to anchor market expectations of future policy rates more firmly around a path warranted by its assessment of the outlook for price stability over the medium term, in July 2013, the Governing Council decided to provide forward guidance. The Governing Council stated that it expected the key ECB interest rates to remain at their prevailing or lower levels for an extended period of time.

Importantly, despite the severe tensions during the financial and sovereign debt crisis and the observed volatility in economic activity and headline inflation, inflation expectations remained firmly anchored at levels consistent with the Governing Council's aim of keeping inflation rates below, but close to, 2% over the medium term.