ARTICLES

HETEROGENEITY IN EURO AREA FINANCIAL CONDITIONS AND POLICY IMPLICATIONS

The current crisis has been associated with significant heterogeneity in financial conditions, following a period of low and more homogeneous financing costs. Money markets have become impaired, especially across national borders, and sovereign bond yields have diverged significantly. Overall, there is increased evidence that country-specific effects have become more important in driving financial conditions.

The financial system is the primary channel through which monetary policy affects the economy and ultimately prices. Stable, efficient and integrated financial markets are the basis for a smooth transmission of monetary policy across countries. The current degree of heterogeneity in financial conditions therefore poses a major challenge for the single monetary policy.

The underlying causes of the increase in heterogeneity originate in the accumulation of fiscal, macroeconomic and financial imbalances in several euro area countries prior to the crisis, fuelled in particular by decreasing interest rates around the start of EMU and by inadequate national and European policy responses. When the crisis erupted, the unsustainable nature of these imbalances became evident. The repricing of risks caused the real imbalances to spill over to financial developments. Financial integration halted as financial flows across euro area countries reversed. Destabilising and self-reinforcing linkages between the deterioration in public finances, the severe economic recession and the fragility of banks' balance sheets triggered a negative feedback loop between fiscal, real and financial developments in certain countries. The lack of a credible backstop mechanism made it difficult to break this negative spiral in a monetary union characterised by decentralised economic policies.

With a view to maintaining price stability in the euro area, the ECB has introduced a number of measures to ensure a more homogeneous pass-through of its key interest rates to the economy. However, these measures cannot provide a structural solution to the underlying causes of heterogeneous financial conditions. Rather, this involves governments acting at the national and the euro area/European levels in the various policy areas where the appropriate policies and mechanisms have to be put in place. Such action is needed, in particular with regard to public finances, structural economic reforms and financial stability. It includes the need to move towards a "financial union", with the further transfer of competences to the European level as regards euro area financial sector crisis management and resolution. Such policies would also create better conditions to support a smooth transmission of monetary policy across countries.

1 INTRODUCTION

The current crisis has been associated with significant heterogeneity in financial conditions. This poses a particular challenge for the conduct and transmission of monetary policy in a currency union such as EMU. More broadly, it raises questions about the appropriateness of the fiscal, structural and financial architecture in the euro area.

The financial system is the primary channel through which monetary policy affects the economy. Stable, efficient and integrated financial markets are the basis for the smooth transmission of monetary policy across countries. Thus, the current heterogeneity in financial conditions poses a major challenge for the single monetary policy.

Although some degree of national differentiation in financial developments is a normal feature of a monetary union, heterogeneity in financial conditions across the euro area has increased significantly, as some countries have been affected more substantially by the financial crisis. Money markets have become increasingly impaired, especially across national borders, and yields in sovereign bond markets have diverged significantly.

The ECB has introduced a number of measures to ensure a more homogeneous pass-through of its key interest rates to the economy. It cannot, however, provide a structural solution to the underlying causes of heterogeneous financial conditions. For that, national governments must put in place the appropriate policies and mechanisms at the national and euro area/European levels. Such policies would also create better conditions for supporting a smooth transmission of monetary policy across countries.

Against this background, this article reviews the causes of heterogeneity in financial conditions in recent years and examines how they relate to macroeconomic imbalances and policy failures before the crisis. It explains the ECB's monetary policy response and discusses the role of other policies – notably fiscal, structural and prudential policies – in overcoming structural imbalances and divergences. Section 2 describes developments in financial conditions over time and relates the return of heterogeneous financial conditions to the sudden repricing of risks after years of accumulated imbalances in public finances, in the macroeconomy and in banking. Section 3 reviews the impact on monetary policy of this renewed heterogeneity, as well as the main actions that the ECB has taken to promote a more homogeneous transmission of monetary policy across the euro area. Section 4 focuses on the need to address the institutional shortcomings of EMU that contributed to the emergence of heterogeneity in order to tackle the crisis. Section 5 draws some conclusions.

2 HETEROGENEITY IN EURO AREA FINANCIAL CONDITIONS OVER TIME

The two decades preceding the crisis witnessed a substantial decline in nominal interest rates and financing costs in all euro area countries. The completion of the Single Market in financial services and deeper financial integration were associated with a strong convergence in financial conditions across euro area countries. In addition to policy initiatives to foster financial integration – for example, the Financial Services Action Plan (FSAP) – other factors contributed to the decline in nominal interest rates: in particular, a more stable and benign economic and financial environment, and a price stability-oriented monetary policy created the conditions for lower interest rates.

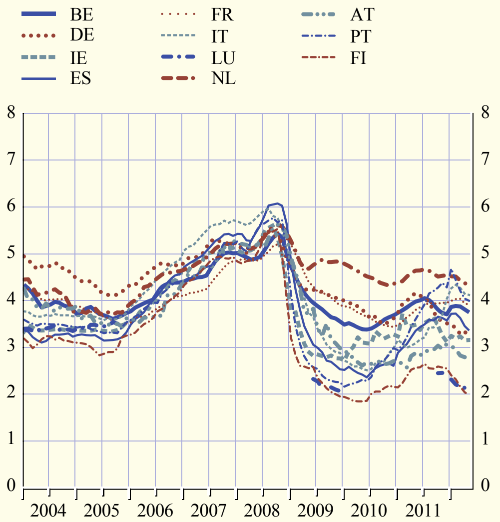
The financial market segment closest to the single monetary policy, i.e. the euro area money market, was highly integrated from the start of EMU. The cross-sectional standard deviation of the EONIA lending rates across euro area countries fell to close to zero following the introduction of the euro. A considerable degree of convergence was also seen in government and corporate bond markets. Charts 1 to 3 illustrate the low level of dispersion in the rates charged by banks to households for residential mortgages and to non-financial corporations for new loans, as well as in sovereign bond yields. The overall result was a low level of heterogeneity in financial conditions across euro area countries.

The financial crisis that erupted in September 2008 with the default of Lehman Brothers, following a period of financial turmoil from August 2007, marked a halt in the trend towards more homogenous financial conditions. Secured and unsecured money markets became increasingly impaired, especially across national borders. Sovereign bond yields also started to diverge at that time, but this became more pronounced following the onset of the sovereign debt crisis in May 2010. This spilled over into corporate bond markets, with effects at the country level becoming a more important driving factor behind yield developments. The return of differentiated financial conditions is also illustrated in Charts 1 to 3.

The resuming heterogeneity in financial conditions mainly reflects differences in the

Chart 1 Interest rates on new loans to households for house purchase

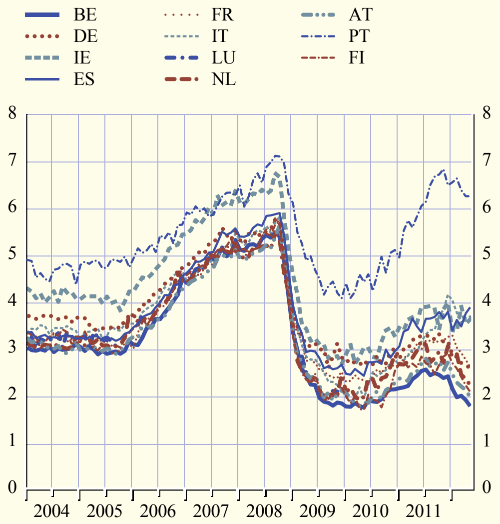
(percentages per annum)



Source: ECB.
Note: Data are not available for all euro area countries over the entire period.

Chart 2 Interest rates on new loans to non-financial corporations

(percentages per annum)



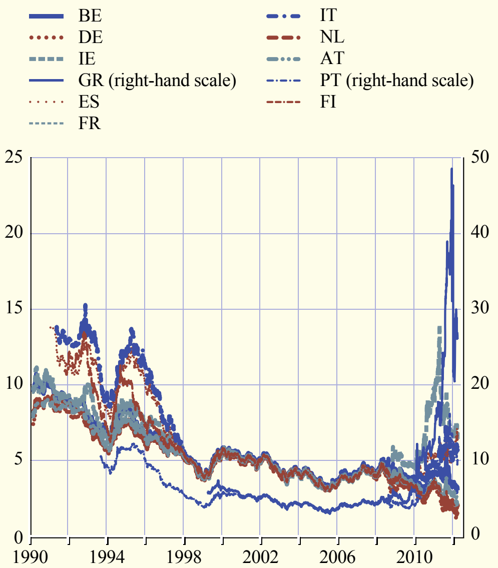
Source: ECB.
Note: Data are not available for all euro area countries over the entire period.

way euro area countries have been affected by the crisis. Prior to the crisis, the convergence of financial conditions masked divergences in national policies and the accumulation of fiscal, macroeconomic and financial imbalances in several euro area countries. These imbalances were not adequately addressed, either at the national or the European level. They created vulnerabilities in these countries and paved the way for the sudden return of differentiated financial conditions when risks were repriced.

Imbalances related, for example, to government financial positions in some euro area countries. Following the start of EMU, government finances benefited from the easier access to financing that emanated from the elimination of exchange rate risk, and an underappreciation of risk by financial market participants. However, progress towards sound and sustainable public finances was limited, owing partly to a loose and, over time, more relaxed interpretation of European budget rules. Market discipline was also weak, as reflected in the very limited

Chart 3 Sovereign bond yields

(percentage per annum)



Source: Datastream.
Note: Data reflect yields on ten-year government bonds, which are not available for all euro area countries over the entire period.

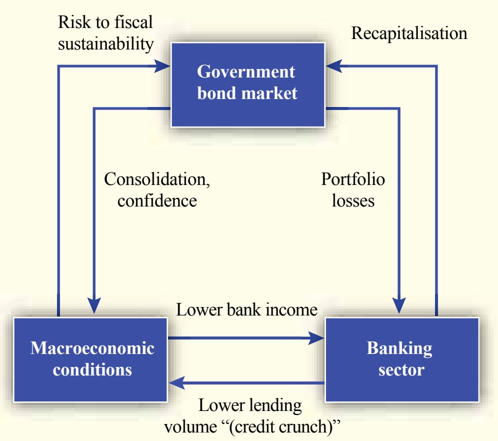
dispersion in interest rates on government bonds. As a result, in particular those governments that had experienced high interest rates before joining EMU witnessed a major relaxation of financial conditions. Structural fiscal positions remained weak and vulnerable to changes in economic and financial conditions.

Imbalances also related to private sector developments. Like governments, households and non-financial corporations benefited from lower financing costs after the start of EMU. This led to increased spending in some countries that had previously experienced high interest rates, including on real estate. As a result of strong domestic demand, inflation rates in these countries were above average. Unit labour costs rose, causing losses in competitiveness, but rigidities in wage and price formation also played a role. Furthermore, owing to the apparently good economic performance, there was less incentive to undertake (politically costly) structural reforms in product and labour markets. This resulted in a deterioration in current account balances and housing booms. Increasing financial integration in the euro area, combined with abundant global liquidity, as well as investors and national supervisors taking insufficient account of increasing risks, provided the necessary financing to these countries; deficits were financed partly by surpluses in other euro area countries. Banks also built up imbalances, as they greatly expanded their balance sheets following the improvement in financial conditions and rise in credit demand from households and corporations. Banks' lending practices and bank supervision were insufficiently prudent to mitigate the heightened risks.

These imbalances created the conditions for increased financial heterogeneity during the crisis. In the private sector, the unsustainable nature of rapidly rising labour costs, house prices and current account deficits in the financially stressed countries (Ireland, Greece, Portugal and, subsequently, Spain and Italy) became clear when economic and financial conditions deteriorated severely and confidence fell with the default of Lehman Brothers. These countries were hit by a severe recession that aggravated problems in public finances and adversely affected banks' balance sheets. A global repricing of risks took place, leading real economic imbalances to spill over to financial developments (see Chart 4 for a depiction of the main linkages between the economy, the banking sector and government bond markets). Financial integration partly halted and reversed, especially when confidence in some national banking systems deteriorated with the sovereign debt crisis.

Banks in the countries concerned suffered from lower credit demand and losses on non-performing loans. Financial concerns increased further from the onset of the sovereign debt crisis in May 2010, with wide government bond spreads creating portfolio losses on national government bond holdings. Reduced confidence in banks' health and in the financial capacity of the national governments concerned to recapitalise banks, if necessary, limited banks' access to money and bond markets. As a result, bank bond spreads widened substantially

Chart 4 Main linkages between the economy, the banking sector and government bond markets



Source: ECB.
Note: Arrows indicate the channel through which deteriorating conditions in one area affect the other two areas. For instance, deteriorating macroeconomic conditions reduce bank's income, e.g. from less lending activity, and increase risks to fiscal sustainability, e.g. as deficits automatically increase, which is likely to be reflected in higher government bond yields.

in the countries most affected by the crisis, despite government guarantees (see Chart 5). This had adverse consequences for banks' lending to the real economy, which were compounded by deleveraging pressures from regulatory requirements, including higher capital requirements.[1]

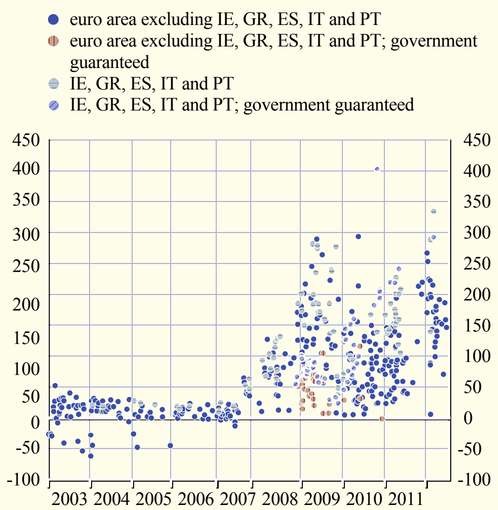
Public finances deteriorated sharply on account of the crisis, against the background of persistently high debt ratios and substantial banking sector support, especially in countries with a very large banking sector in relation to GDP. Rapidly increasing public deficits, debt and contingent liabilities raised questions about the sustainability of public finances in some euro area countries, as reflected in higher sovereign bond yields (see Chart 3) and a drying-up of liquidity in some markets. The sovereign debt crisis that erupted in May 2010 was initially centred around adverse fiscal developments in Greece, but then spread to Ireland and Portugal; at a later stage, Spain and Italy also became the subject of intensified market scrutiny. The lack of confidence in governments' willingness to tackle the crisis, in combination with the lack of an effective resolution mechanism, also spread to other governments. This phenomenon is referred to as "contagion".

Financial integration halted partly with a reversal of the financing flows to the countries in question, as can be seen from government debt securities being increasingly purchased domestically, with non-domestic euro area banks selling these bonds (see Chart 6).[2]

1 For further information on developments in lending to the real economy, see the article entitled "Assessing the financing conditions of the euro area private sector during the sovereign debt crisis" in this issue of the Monthly Bulletin.
2 Another indication of decreased financial integration in the euro area is the relative decline in the use of non-domestic collateral in the Eurosystem's refinancing operations. For further details, see *Financial integration in Europe*, ECB, Frankfurt am Main, April 2012, p. 68.

Chart 5 Bank bond spreads at issuance by country group with and without government guarantee

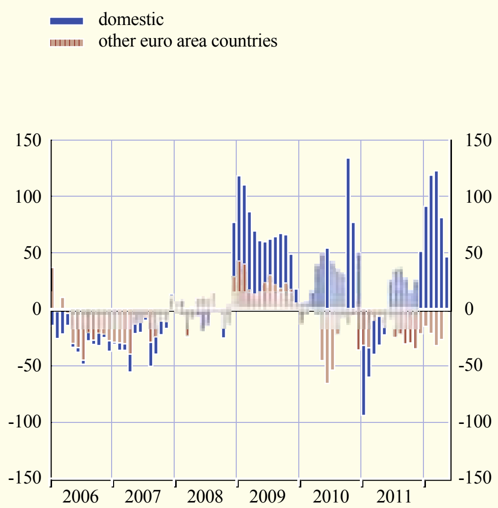
(basis points)



Sources: Bloomberg, Dealogic DCM Analytics and ECB calculations.
Notes: Spreads are computed with respect to swaps. Data relate to the country of operation of the issuer, on an unconsolidated basis. The chart includes senior unsecured fixed rate investment-grade bonds and medium-term notes with a time to maturity at issuance of between one and ten years. Only euro-denominated issuances with a face value of at least €100 million are included.

Chart 6 MFI purchases of government debt securities

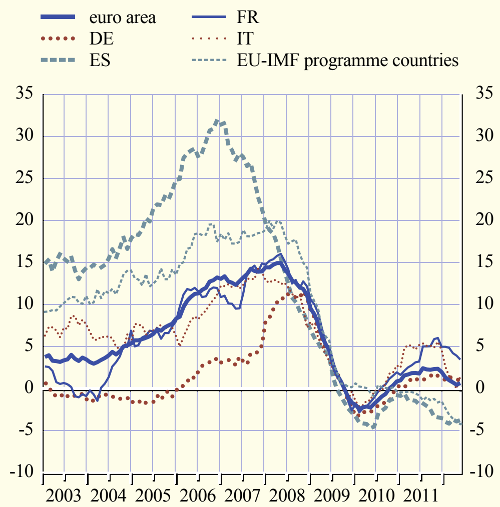
(three-month flows in EUR billions; seasonally adjusted)



Source: ECB.
Note: The chart shows purchases by MFIs in one euro area country of government debt issued by that country and purchases of that debt by MFIs in other euro area countries.

Chart 7 Loans to non-financial corporations (adjusted for securitisation)

(annual percentage change)



Source: ECB.
Note: "EU-IMF programme countries" refers to Ireland, Greece and Portugal.

The reversal of financing flows severely affected loan supply to the private sector. As Chart 7 shows, the growth rate of loans to non-financial corporations, for instance, turned negative around the end of 2009 and did not subsequently recover in the countries subject to an EU-IMF adjustment programme (i.e. Ireland, Greece and Portugal) or in Spain, although it did recover in the other euro area countries. Apart from supply-side factors, this also reflects subdued demand from non-financial corporations on the back of weak growth prospects, while some of the largest non-financial corporations may have increased their recourse to bond market financing.

Tackling the problems in public finance, in the macroeconomy and in banks' balance sheets is complicated because of their close linkages. During a crisis, these links may be destabilising and potentially self-reinforcing. For instance, substantial holdings of domestic government debt in their portfolios made banks in the affected countries vulnerable to rises in government bond yields, while at the same time, the weakened financial position of domestic banks required those governments to finance additional support to the banking sector. Breaking such a negative feedback loop in a monetary union that is characterised by decentralised economic policies is complicated further by a lack of effective supranational institutions as regards public finances, structural reforms and competitiveness, as well as financial stability.

3 THE ECB'S RESPONSE TO INCREASED FINANCIAL HETEROGENEITY

An integrated financial market with broadly homogeneous financial conditions is the basis for a smooth transmission of monetary policy across the euro area. However, financial conditions in the countries of the euro area have never been identical, given differing financial structures across countries. This has caused some differentiation in the transmission of monetary policy, given the predominantly bank-based nature of financing to households and non-financial corporations in the euro area; but as long as financial heterogeneity was limited, it was not a source of concern. However, during the various phases of the crisis (i.e. the financial turmoil from August 2007, the financial crisis starting in September 2008 and the sovereign debt crisis as of May 2010), financial heterogeneity has increased significantly, reaching levels not seen so far during EMU.

As a result, the ECB's monetary policy stance could no longer be transmitted to short-term and longer-term interest rates, as in the past, with rates reflecting increased market and liquidity risk. With the financing conditions of banks also affected, there was the risk that credit flows to households and corporations would dry up, impairing the effectiveness of monetary policy and creating downside risks to price stability in the euro area as a whole.

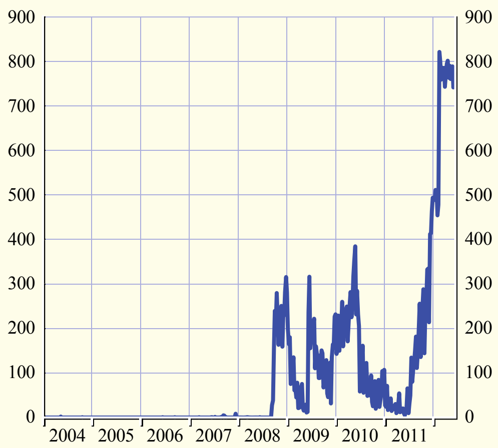
In response to the exceptional degree of financial heterogeneity, the monetary policy of the ECB continued to be guided by its mandate of maintaining price stability for the euro area as a whole. Key ECB interest rates were reduced sharply, given the deep financial crisis that had caused downside risks to price stability in the medium term. In addition, non-standard measures were taken to support the functioning of the transmission mechanism, by bringing back liquidity to dysfunctional markets. This was to ensure that the very low interest rates were transmitted to the entire euro area economy and ultimately to prices.

Over time, the ECB's non-standard measures – while being open to banks in all countries – have been used more intensively in the financially troubled countries of the euro area. The cross-country differences in the use of these measures largely reflect heterogeneity in financial conditions across the euro area and have supported the effective conduct of the single monetary policy. The measures focused in particular on the money market and later also on the sovereign bond market.

Funding conditions in interbank money markets worsened in each phase of the crisis as a consequence of banks' deteriorating confidence in their counterparties. Forestalling a curtailment of financing to the real economy that would have hurt economic growth and employment, and thereby price stability, the ECB gradually stepped up its intermediation role between banks.[3] As a result, excess liquidity in the interbank money market – i.e. the amount of central bank liquidity over and above what is needed for financing autonomous factors and reserve requirements – increased significantly. The aggregate position is normally close to zero, with abundant liquidity at one bank being channelled to a bank with a deficit via the money market, and no deposits being placed with the Eurosystem. However, a decreased willingness to lend to "suspect" banks, especially across national borders, hampered the distribution of liquidity to those banks that needed it most. Individual banks had to take up more central bank money themselves to be sure of having enough liquidity, and excess liquidity was placed in the deposit facility. The rise in deposits with the Eurosystem is therefore a good indicator

Chart 8 Recourse to Eurosystem's deposit facility

(EUR billions)



Source: ECB.

of the degree of disintermediation in the money market (see Chart 8).

Restricted access to the money market affected banks – particularly in countries in which government finances had deteriorated substantially – on account of the linkages between banks and sovereigns. For the same reason, other markets for the financing of banks, such as the market for bank bonds, also became less accessible. It was also likely that these funding restrictions would hamper the growth of credit to households and non-financial corporations. This, together with deleveraging needs, could well have resulted in a credit crunch in several parts of the euro area, with downside effects on the economy and price stability in the euro area as a whole.

Therefore, the ECB adopted various non-standard measures aimed at enhancing credit

3 For an overview of the Eurosystem's non-standard measures, see the article entitled "The ECB's non-standard measures – impact and phasing-out", *Monthly Bulletin*, ECB, Frankfurt am Main, July 2011. The main measures taken subsequently are described in the box entitled "Statement by the President of the ECB on 7 August 2011", *Monthly Bulletin*, ECB, Frankfurt am Main, August 2011, and in the box entitled "Additional non-standard monetary policy measures decided by the Governing Council on 8 December 2011", *Monthly Bulletin*, ECB, Frankfurt am Main, December 2011.

growth by correcting the negative effects that the money markets were having on the transmission channels. For example, in October 2008 the ECB decided to adopt a fixed rate tender procedure with full allotment in its refinancing operations. Given the constraints in the funding markets for banks, the maturities of the longer-term refinancing operations (LTROs) were also successively extended, up to three years for the operations conducted in December 2011 and February 2012. Moreover, the already broad collateral framework has been extended further, with corresponding risk control measures to mitigate the Eurosystem's risk exposure. This action has given collateral-constrained banks the opportunity to still participate in refinancing operations.

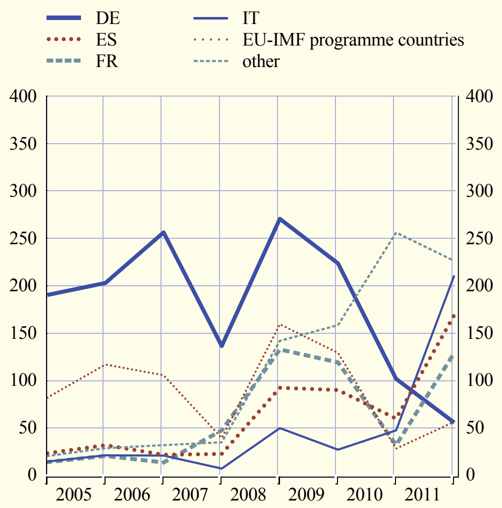
As a result of the ECB's greater intermediation role in the money market, the use of its refinancing facilities increased dramatically, with a corresponding expansion of the Eurosystem's balance sheet. Chart 9 shows that recourse to refinancing operations was especially high for banks in those countries most affected by the crisis. At the end of 2008 and 2009 it was at elevated levels in the countries subject to an EU-IMF adjustment programme. In 2011 it was banks mainly in Italy, Spain and France that drove demand for ECB refinancing. The very high levels of participation in 2011 reflected the allotment of the first three-year LTRO. By contrast, recourse to refinancing operations by German banks decreased, reflecting capital inflows.

The degree of heterogeneity in banks' financing needs can also be seen from TARGET2 balances (see Chart 10).[4] TARGET2 is the Eurosystem's real-time gross settlement system. NCBs' balances reflect their net claim/liability that results from commercial banks' cross-border payments via TARGET2. The increasing

4 For more details, see the box entitled "TARGET2 balances in the Eurosystem in a context of impaired money markets", *Annual Report 2011*, ECB, Frankfurt am Main, April 2012.

Chart 9 Participation in refinancing operations

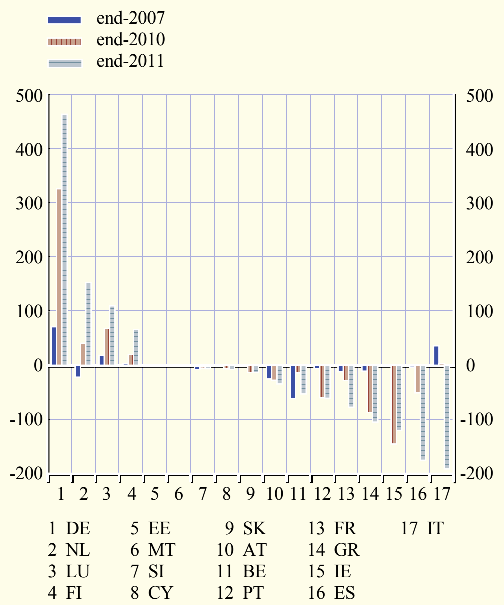
(EUR billions)



Source: NCBs.
Note: "EU-IMF programme countries" refers to Ireland, Greece and Portugal. Data show end-of-year figures.

Chart 10 TARGET2 balances

(EUR billions)



Source: NCBs.

TARGET2 liabilities of some NCBs mainly reflect funding stress in their respective banking systems, with financial outflows being compensated by increased recourse to the Eurosystem's refinancing operations.

From May 2010 government bond markets became adversely affected alongside a sudden and sometimes excessive repricing of risks. Malfunctioning in some government bond markets was reflected in the drying-up of liquidity. Changes in the key ECB interest rates are normally transmitted via short-term market rates along the yield curve to longer-term rates and to the economy, but this process was hampered in those countries with malfunctioning government bond markets. These markets play an important role in the transmission process (e.g. by generally setting a floor for corporate bonds and acting as a primary source of collateral in repo transactions). Without further action, more bond markets would have been likely to be affected via contagion, with negative repercussions on the funding of the economy, economic growth, employment and price stability.

Therefore, in May 2010 the ECB started to purchase bonds of some governments outright in the secondary market under its Securities Markets Programme (SMP). After a period of relative calm at the beginning of 2011, interventions increased again in the second half of that year. The ECB acted in markets where liquidity was at very low levels, thus helping to repair the usual transmission process.[5] In addition, the refinancing operations, and in particular the three-year LTROs, have supported sovereign bond markets, as some banks decided to use part of the liquidity to buy government bonds.

4 THE ROLE OF FISCAL, MACROECONOMIC AND FINANCIAL POLICIES IN ADDRESSING THE INSTITUTIONAL SHORTCOMINGS OF EMU

The linkages between fiscal, structural and financial imbalances that led to the sovereign debt crisis and the fragmentation of financial markets, as described in the previous sections, have revealed several shortcomings in the institutional set-up of EMU. This section first reviews the weaknesses in the institutional design prior to the crisis; second, it describes the progress achieved so far in addressing said shortcomings; and third, it looks at what still remains to be done.

The crisis has highlighted two major weaknesses in the institutional set-up of EMU. First, the policy framework in place to ensure economic and financial convergence across euro area countries and foster flexibility of their economies is not fully effective. Incentives and rules to support sound national fiscal, financial and macroeconomic policies were not sufficient to prevent imbalances from building up prior to the crisis. Furthermore, the absence of an explicit mechanism for correcting imbalances has led to a delay in necessary adjustments in several countries. Structural rigidities, in turn, caused these adjustments to be more costly once the crisis erupted.

Second, the pre-crisis financial stability framework was characterised by a limited degree of harmonisation and coordination across euro area countries. The absence of any euro area-wide financial stability and crisis management made it challenging to identify and correct systemic risk prior to the crisis; and it was equally challenging to contain the spread of financial instabilities across countries and markets when this risk actually materialised. The crisis management and financial sector repair, such as the rescue and resolution of financial institutions, was left to national authorities, despite large cross-border activities in the financial sector. This resulted in the retrenchment of the financial system within national borders, sowing the seeds for the subsequent adverse feedback loop between sovereigns' and banks' financial conditions.

5 To preserve the effectiveness of these monetary policy operations, the Eurosystem does not provide information on the country distribution of SMP interventions.

Heterogeneity manifested itself not only through increased divergence, but also through greater contagion in the absence of a credible institutional backstop. Powerful propagation and amplification mechanisms emerged – from the sovereign market to the banking sector, from the financial to the real sphere, and across borders – so that deteriorating conditions in one particular country had the potential to affect the euro area as a whole.

Addressing these shortcomings is necessary to restore more homogenous financial conditions and eliminate financial imbalances. This will be crucial for monetary policy to operate more effectively and ensure its smooth transmission to the euro area economy as a whole. As already discussed in Section 3, although the ECB's non-standard measures can bring temporary relief, they do not tackle the underlying causes of the prevailing financial imbalances. This can only be achieved through policy measures at the national and euro area/European levels. In particular, macroeconomic policies need to address general financial imbalances, whereas financial policies should aim to achieve more homogenous financial conditions.

Recognising the need to address these shortcomings has led to a series of overarching reforms relating to the overall economic governance framework, financial supervision and regulation, and crisis management.

First, some measures have been taken at the European level to enhance fiscal discipline and the competitiveness of euro area economies. Almost all EU Member States have signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, which includes the "fiscal compact", featuring the adoption of budget rules and correction mechanisms within national legislation. Euro area-wide macroeconomic surveillance has also been strengthened through the adoption of different measures, such as the "six pack" and the "two pack", which are intended to enhance the prevention and correction of fiscal and macroeconomic imbalances.[6] Besides greater peer pressure, the reformed framework is also intended to reinforce market discipline by making it easier for markets to monitor national policies.

Second, progress has been made regarding the euro area financial framework. The need to detect and address systemic risk led to the creation of the European Systemic Risk Board (ESRB) for macro-prudential policy, whereas the coordination of micro-prudential supervision was reinforced by the establishment of three different European authorities. The aim of the reform of the supervision framework was to improve the quality and consistency of supervision, reinforce the supervision of cross-border groups, strengthen crisis prevention and management across the euro area, and establish a set of common standards applicable to all financial institutions (i.e. a "single rulebook"). Regarding financial regulation, the current overhaul of the regulatory framework and the capital adequacy targets set at the European level should help to strengthen the banking system, prevent excessive leverage and foster the provision of credit to the economy. Other important regulatory reforms are also under way, in areas such as short selling, credit rating agencies' regulation, the "shadow banking system", and the establishment of an appropriate regulatory framework for over-the-counter derivatives.[7] Moreover, another non-crisis-related project, namely TARGET2-Securities, should contribute to safer processing, improved efficiency and lower costs for cross-border transactions, thereby supporting more integrated euro area financial markets.

Third, and lastly, the need to tackle contagion was addressed through the establishment of the

6 These issues have been dealt with in more detail in the article entitled "Monetary and fiscal policy interactions in a monetary union", *Monthly Bulletin*, ECB, Frankfurt am Main, July 2012, and in the article entitled "A fiscal compact for a stronger Economic and Monetary Union", *Monthly Bulletin*, ECB, Frankfurt am Main, May 2012. The remainder of this section therefore focuses primarily on supervision issues.

7 These issues have been dealt with in detail in the Special Feature D entitled "Institutional reform in the European Union and financial integration", *Financial Integration in Europe*, ECB, Frankfurt am Main, April 2012.

European Financial Stability Facility (EFSF) and its successor, the European Stability Mechanism (ESM). The ESM will provide temporary financial support to euro area countries, with the aim of providing bridge funding for the period of time needed to implement a deep adjustment programme to correct imbalances and regain market access, thus avoiding contagion through destabilising cross-country spillovers.[8]

Looking ahead, it is important that governments deliver on the agreed measures. These measures constitute a significant improvement to the institutional framework, and, if implemented, should reinforce the resilience of the euro area financial system and help to mitigate the risks of the vicious spirals of instability and heterogeneity seen during the crisis. That being said, further policy actions may be needed, such as structural financial sector policies, further policies to address macro-financial imbalances, and policies aimed at achieving better crisis management and resolution. In particular, a harmonised bank recovery and resolution regime at the European level would help to break the link between sovereigns and banks that has contributed significantly to the development of substantial financial heterogeneity in the euro area, including the build-up of contagion risks. At the same time, it would also help to reduce the heterogeneity in interbank activity and financial flows, as reflected in the TARGET2 balances.

Generally speaking, policies need to be directed towards more integrated euro area financial markets that are both more efficient and more resilient. In this regard, the benefits of integrated financial markets are manifold. They support balanced monetary and financial conditions and thereby foster a smooth transmission of monetary policy within the euro area. They also improve the resilience of the financial system through increased competition, more liquid markets and better diversification and risk sharing. At the same time, as evidenced by the crisis, an incomplete process of financial integration – with increased cross-border interactions, but no safeguards in place to address systemic risk – can pose substantial threats to financial stability and economic growth.

With respect to supervision, crisis management and resolution policies, the need for adequate instruments to deal with financial crises in a monetary union can be illustrated by means of two polar cases. In the first case, regulation, supervision and crisis management would continue to be organised along national lines, with some elements of cross-border cooperation. Such a framework would, however, require much more stringent rules and closer cooperation – especially to deal with systemic institutions, i.e. the “too big to fail” problem – than has been the case in the euro area so far. In the second case, regulation, supervision and crisis management are centralised, and the pooling of risks across countries would de facto create a financial union. Resources to rescue the financial system, from private or public sources, would be pooled into a single central mechanism, increasing efficiency compared with a situation in which each country has its own authority.

Against this background, several proposals have been made for an EU framework for bank recovery and resolution (see the box). The latest proposal by the European Commission represents progress towards a financial union and a step forward compared with the pre-crisis situation, in which national regimes were not harmonised and lacked resolution authorities. The euro area summit of 29 June 2012, which laid the foundations for an effective single supervisory mechanism, is an important step in the right direction. Further progress, however, needs to be made, especially with regard to a euro area deposit insurance scheme and the setting-up of a truly integrated resolution regime to address the issue of cross-border systemically important financial institutions.

8 See the article entitled “The European Stability Mechanism”, *Monthly Bulletin*, ECB, Frankfurt am Main, July 2011.

Box

TOWARDS A NEW EU FRAMEWORK FOR BANK RECOVERY AND RESOLUTION

The financial crisis has highlighted the need for an EU framework for bank recovery and resolution, ideally based on the new international standard on resolution regimes (Key Attributes of Effective Resolution Regimes for Financial Institutions), published by the Financial Stability Board (FSB) in October 2011. The new framework should pursue two equally important and interrelated objectives: i) reducing the risks of taxpayers by ensuring that banks can be allowed to fail in an orderly way; and ii) breaking the link between banks and sovereigns which has created a vicious circle in some EU Member States. To satisfy these two goals, the EU's resolution regime needs to ensure that the financial industry bears the costs of resolution by means of a credible, efficient resolution financing arrangement, using resolution tools that allow for losses to be imposed on shareholders and creditors.

On 6 June 2012 the European Commission presented its proposal for a new EU framework on bank recovery and resolution, which includes elements for prevention (e.g. resolution and recovery plans) as well as for early intervention and resolution. In accordance with the FSB's Key Attributes, the Commission's proposal provides the resolution authorities with a common toolkit, consisting of a series of powers and tools (i.e. the bridge bank, the sale of business, the asset separation and bail-in) that would allow them to deal with banks in difficulty – as a going concern (i.e. through bail-in) or as a gone concern (i.e. through a bridge bank or a combination of resolution tools). The directive also introduces a European system of financing arrangements composed of: i) national financing arrangements; ii) the borrowing between national financing arrangements; and (iii) the mutualisation of national financing arrangements in the case of a group resolution. Such financing arrangements would be supported by contributions from banks, so that in a period of no longer than ten years after the entry into force of the directive, the available financial means of the financing arrangements amount to at least 1% of the value of the covered deposits.

The European Commission's proposal represents a significant step forward from the current situation, in which national regimes lack the necessary resolution powers and there is an insufficient level of harmonisation. The initiative to create a common EU language for resolution that is very close to the international standard will not only facilitate the handling of future crises, but also improve cooperation between the relevant authorities across jurisdictions. A key priority, therefore, for the near future is the consistent implementation of the directive among the EU Member States and the FSB's Key Attributes at the international level. However, how all this will work in practice for large cross-border banks in the EU's Single Market remains an open question.

The financial crisis has highlighted the complexity of resolution for the cross-border systemically important financial institutions. In this respect, the EU needs to make further progress towards a truly integrated resolution regime that adequately reflects the cross-border nature of its banking sector. Such an integrated resolution regime would enhance market discipline by mitigating moral hazard, maintain stability by ensuring the continuity of basic services of institutions being wound up, allocate losses efficiently and protect taxpayers.

The medium-term vision for such an integrated resolution regime could ultimately be the establishment of an EU-level resolution authority responsible for all the major cross-border banks in the EU. Such an authority would work on the basis of a single crisis management, resolution and insolvency framework for EU banks. Developments along these lines are already taking place in the field of prudential regulation. The decision taken at the euro area summit of 29 June 2012 to introduce a single supervisory mechanism on the basis of Article 127(6) of the Treaty on the Functioning of the European Union represents an important step towards a financial union. This will be coupled with the implementation of the new Basel rules, which will partly take the form of an EU regulation, thereby eliminating the room for national differences in transposition.

Such an integrated resolution system should be based on robust arrangements to finance the measures of the EU resolution authority. These arrangements should be shaped in such a way that the thorny issue of public burden-sharing is replaced, insofar as possible, by private burden-sharing. To this end, resources could be pooled in a single pan-EU resolution fund. This would help to break the link between the creditworthiness of banks and that of their sovereigns and, at the same time, ensure a level playing field and consistent application of the relevant rules throughout the EU.

5 CONCLUSION

The financial and sovereign debt crisis has greatly increased the degree of heterogeneity in financial conditions in the euro area. Unsustainable public finances, large macroeconomic imbalances and impaired domestic banking systems have led to a deterioration in financial conditions in some parts of the euro area where the financial benefits of entering EMU had been particularly large and rising imbalances were not contained by appropriate policies.

This high degree of heterogeneity posed challenges for the conduct of the single monetary policy. Nevertheless, the ECB's monetary policy has contributed to alleviating heterogeneity in financial conditions. Throughout the crisis, the ECB's measures have continued to be guided by its mandate of maintaining price stability in the euro area as a whole, helping to reduce uncertainty and related risk premia in interest rates. The ECB's non-standard monetary policy measures, such as the three-year LTROs and the SMP, supported money market and bond market conditions in the financially troubled countries, and contributed to ensuring a more homogeneous transmission of the euro area's monetary policy.

However, the ECB's non-standard measures are only temporary in nature and cannot tackle the underlying causes of financial imbalances and heterogeneous financial conditions. Structural corrections are needed as regards public finances, macroeconomic imbalances and financial stability, which are the responsibility of the national governments of the euro area countries. Appropriate policies are already being implemented, in part, at both the national and euro area/European levels, but these may require faster implementation than is currently foreseen, as well as additional decisive steps. These include the further transfer of competences to the European level as regards euro area financial sector crisis management and resolution, hence a move towards a financial union. The decision taken at the euro area summit of 29 June 2012 to introduce a single supervisory mechanism on the basis of Article 127(6) of the Treaty on the Functioning of the European Union represents an important step in the right direction.