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Euro area and its Banking Sector: Perspectives of long-term Development

Abstract

The path of the banking system from national level to global players being interconnected through the market integration has been a long journey and is still going on. The paper provides a historic overview of the monetary integration process but also the current status of the banking levels. It is supposed to show the need, the causes for the establishment of additional institutions in order to maintain the stability within the integration process. Also it shows why the necessity occurred to introduce new institutions like the Banking and Capital Market Unions. The aim of the paper is to present briefly the monetary integration process and everything it has brought with it. We have seen that the banking efficiency has been improved anyway as the market has become more stabilized. Although the banking market has slightly changed in its composition due to the global environment, it has remained rather stable during the financial and Covid crises.

Keywords

Banking sector, monetary union, banking and capital market union, banking efficiency

JEL classification

G20, H12, F62, E52

Introduction

Monetary integration has been one important element and driving force in this process, but by far not the only one. Others include the emergence of the Euromarkets in the 1950s and 1960s, regional exchange-rate arrangements, individual countries' financial liberalization efforts and the EU Single Market program. Additionally, the monetary integration process has caused the implementation and establishment of the EU Banking Union and European Capital Market Union. Beside, not all influences were policy induced. At times, market forces played a decisive role. The paper intends to provide a historic overview of the monetary integration process but also the current status of the banking levels. It is supposed to show

the need, the causes for the establishment of additional institutions in order to maintain the stability within the integration process.

1 Monetary Integration

On 24 April 1972, EEC central-bank governors concluded the 'Basel Agreement', creating a mechanism called the 'Snake in the tunnel'. Under this mechanism, Member States' currencies could fluctuate (like a snake) within narrow limits against the dollar (the tunnel) and central banks could buy and sell European currencies, provided that they remained within the fluctuation margin of 2.25%. The original participants in the mechanism were France, Germany, Italy, Luxembourg and the Netherlands. Denmark, Norway and the United Kingdom joined shortly afterwards. (European Parliament, 2015)

The introductory rudiments of EMS were the description of the European Currency Unit (ECU) as a handbasket of public currencies and an Exchange Rate Mechanism (ERM), which set an exchange rate towards the ECU for each sharing currency. On the base of those' central' rates, bilateral rates were also established among Member States. The system also included a preventative tool to avoid breaking the set exchange rates. The early times of the EMS saw modest results. According to experts, the turning point came in 1983 when the' French government decided to follow a franc stronghold policy, in which financial policy nearly followed that of the German government and came decreasingly request acquainted.' (Solomon, 1999) By committing to EMS discipline, France and other affectation-prone countries achieved a reduction in affectation and their interest rates gathered to a lower position. (European Parliament, 2015)

1.1 Towards an Economic and Monetary Union

Despite these stabilization efforts, the destabilizing effects of deregulating international financial capital movements under the Single European Act, and the diverging national monetary and fiscal policies of EMS members such as the UK and reunified Germany. combined with uncertainties related to the ratification of the Maastricht Treaty, led to increasing market speculation, culminating in a currency crisis during 1992-93, forcing some Member States (the UK and Italy) to leave the ERM and some others (Spain and Portugal) to devaluate their currency. This move, as well as the positive result of the second referendum in Denmark (after the Edinburgh Agreement and its opt-out from the EMU) eased tensions and the project went forward with the creation of the European Monetary Institute, charged with ensuring

the coordination of Member States' monetary policies and providing surveillance. (Chang, 2009)

Going further, the Cannes European Council in June 1995 confirmed that the year 1999 would be the starting date for the Economic and Monetary Union and European leaders at the Madrid European Council in December decided to name the new European currency the 'euro'. With the date for the launch of the EMU approaching, public skepticism towards monetary integration grew, especially in Member States with strong currencies, like Germany, which were concerned about maintaining price stability. At the same time, other countries such as France and Spain were more concerned about growth than price stability. This led the European leaders' meeting in Dublin in December 1996 to propose a Stability and Growth Pact, which was a compromise between a German proposal for the creation of a Stability Pact – which would maintain convergence obligations after Member States joined the euro area – and the French, Spanish and Italian concerns that excessive focus on budgetary discipline would be at the expense of growth. (Chang, 2009)

In June 1997, the European Council adopted a Resolution to set up an exchange rate mechanism after the creation of the euro area in 1999. This mechanism, called 'ERM II' because it essentially replaced the ERM mechanism of the EMS, fixed the exchange rate of non-euro area Member States against the euro and allowed it to fluctuate only within set limits, to ensure that exchange rate fluctuations between them would not impact on the economic stability of the single market. Meanwhile, the Member States considerably increased their efforts towards convergence: whereas in 1997 only Finland, Luxembourg and Portugal had achieved all the convergence criteria, by May 1998, the Council decided that 11 Member States satisfied the necessary conditions. Finally, in July 2000, the Council agreed that Greece also fulfilled the convergence criteria – although it needed to continue the intensive structural reforms undertaken – and could therefore adopt the single currency. (Chang, 2009)

1.2 The euro area before and after the crisis

The years between the introduction of the euro and the global financial crisis are generally considered as a positive period for euro-area economies. According to (Mongelli et al., 2008), the value of imports and exports of goods within the euro area increased from 26% of GDP in 1998, to 33% of GDP in 2007. In the same period, intra euro area services trade also went up, from 5% to 7% of GDP. Baldwin, Skudelny and Taglioni (2008) found that the EMU had a significant impact on trade flows with non-EMU countries: third countries traded up to 27% more with EMU countries since the creation of EMU. Inflation rates dropped and converged

among euro-area countries. (OECD, 2005) Mongelli and Wyplosz (2006) observed that this price stability benefited consumers and companies. Moreover, low interest rates have lowered the cost of servicing high public debts. Mongelli et al. (2008) notes that EMU has been associated with 'a substantial increase in cross-border financial integration across the euro area' which in turn, 'has stimulated financial development (...), through the lowering of transactions costs and the expansion in the volumes of financial assets'.

Euro area Member States and institutions are fighting the crisis on different fronts: economic governance was strengthened through a number of initiatives; at the same time, facilities and mechanisms were created to provide assistance and support to Member States in financial difficulties and a Banking Union was founded, to restore financial stability in the euro area, through a safer financial sector and a better integrated banking system; finally, non-standard monetary policy measures were introduced, to maintain price stability, stabilize the financial situation and limit financial contagion to the real economy. Thus, financial system collapse was avoided, while foundations were laid for the sector's long-term stability.

2 European Banking Union and Capital Market Union

As mentioned above, the process of monetary integration has caused the establishment of the banking and capital market unions.

The need for a banking union emerged from the financial crisis of 2008 and the subsequent sovereign debt crisis. It became clear that, especially in a monetary union such as the euro area, problems caused by close links between public sector finances and the banking sector can easily spill over national borders and cause financial distress in other EU countries.

The purpose of the banking union is to make european banking more: transparent by consistently applying common rules and administrative standards for supervision, recovery and resolution of banks; unified by treating national and cross-border banking activities equally and by delinking the financial health of banks from the countries in which they are located; and safer by intervening early if banks face problems in order to help prevent them from failing, and – if necessary – by resolving banks efficiently. (ECB, 2022)

The other establishment that emerged from the monetary process and due the recent crises is the capital markets union.

The capital markets union (CMU) is a plan to create a single market for capital. The aim is to get money – investments and savings – flowing across the EU so that it can benefit consumers, investors and companies, regardless of where they are located.

A capital markets union will (1) provide businesses with a greater choice of funding at lower costs and provide SMEs in particular with the financing they need; (2) support the economic recovery post-Covid-19 and create jobs; (3) offer new opportunities for savers and investors; (4) create a more inclusive and resilient economy; (5) help Europe deliver its new green deal and digital agenda; (6) reinforce the EU's global competitiveness and autonomy and (7) make the financial system more resilient so it can better adapt to the UK's departure from the EU. (European Commission, 2021)

2.1 The Costs and Benefits of Monetary Union

The traditional optimum currency area literature identified the elimination of transactions costs and the trade-creating effects of lower exchange rate variability as being the principal benefits of extending the domain of a single currency. The cost, of course, is the loss of the exchange rate instrument as a means of responding to disturbances that affect different regions differently.

In an exceptionally thorough and professional study of the consequences of monetary union, the Commission of the European Communities has attempted to quantify these costs and benefits and has also identified other ways in which monetary union can have an impact on national economies. The Commission study identifies 16 different mechanisms by which economic and monetary union can affect economic performance. These mechanisms are grouped under five main headings. The Commission wisely does not attempt to arrive at a "bottom line" that provides a quantified balance of benefits versus costs. The tone of the report, however, is that the benefits are greater than the earlier literature has suggested, and the costs much smaller and transitory. Moreover, since many benefits accrue at the conclusion of the transition process, the advantages of rapid progress are overwhelming. (ECB, 2022)

Since its establishment, the European Union has progressively made a series of reforms in order to improve the integration of European financial markets. The banking sector is one of the most important aspects not only of the financial markets, but also of the economy, as it is the main channel through which enterprises are financed. European integration was expected to contribute to a more efficient banking sector (European Central Bank, 2005). Thus, the banking industry experienced profound changes and reforms aiming at fostering integration of banking services across the E.U. Nonetheless, European banking integration still confronts certain obstacles as European member-countries have different national characteristics and legal systems, which means that complete banking integration is not yet close to being

achieved (Weill, 2009; Matousek et al., 2015; Kalemli-Ozcan et al., 2008; Stavaarek et al., 2012).

The introduction of the common currency (the euro) represents one of the most important steps towards banking sector integration and this analysis aims at testing the hypothesis that an advanced level of financial integration is associated with higher convergence of efficiency in banking.

For instance, Casu and Molyneux (2003) apply a nonparametric D.E.A approach and a Tobit regression approach for European Union banks, throughout the period 1993–1997 and proved that the differences in the efficiency of the sample are mainly attributed mainly to country-specific factors. Kolia and Papadopoulos (2020a) investigate the relationship among capital, risk and efficiency in the Eurozone and the US banking systems and take into consideration environmental variables.

The basis for regulation of the banking industry is the interest to protect consumers and the systemic risks in the banking market. Because of informational asymmetries, consumers are not able to assess the safety and soundness of financial institutions which therefore requires official intervention and regulation (Dewatripont and Tirole 1995). Moreover, banks are seen as being particularly prone to systemic risk and vulnerable to contagion, for instance, in the form of fast-spreading bank-runs leading to sector-wide illiquidity and (if unchecked) bankruptcy. Thus, individual crisis-prevention entails sizable positive externalities, while much of the associated effort takes the form of private costs.

As a consequence, supervision and regulation is needed to ensure prudential banking and sufficient risk reduction efforts at the bank level (De Bandt and Hartmann, 2000). Besides regulation and monitoring a safety net is provided by Lender-of-Last-Resort, often assumed to be the central bank, which should intervene in case of a systemic crisis and lend to those banks which are temporarily illiquid (Goodhart and Huang 1999, Giannini 1999).

In 2010, the European Banking Authority (EBA) has been established by the European Parliament, replacing the Committee of European Banking Supervisors (CEBS). It is a regulatory body that strives to maintain financial stability throughout the European Union’s (EU) banking industry.

2.2 Current Challenges

In the words of Jean Monnet, one of the EU’s founding fathers: “People only accept change when they are faced with necessity, and only recognize necessity when a crisis is upon them.”

In the past couple of years, the EU has experienced a wide series of different challenges: inflation and recession, Brexit, the coronavirus and now the Russian invasion of Ukraine. The effects of the financial crisis on the EU were on of the first threats to the EU stability. The monetary union as conceived by the Maastricht Treaty previously had been a not finished project lacking adequate mechanisms for financial solidarity among member states in cases of emergencies. When the output of the U.S. sub-prime mortgage crisis hit EU, Europe's financial system came close to collapse. But the impact of the crisis was uneven among the EU member states. Southern European members for example, suffered a great deal more than others. They not only fell into a deep recession but also had to implement harsh monetary and fiscal policies imposed by Northern European members as the condition for the bailouts they received.

Instead of a "break-up", the EU members came up with a healing plan which included emergency funding programs, fiscal policy amendments and the act of bond purchase programs conducted by the European Central Bank. Herewith, the EU proved that its togetherness was a stronger crises-coping-mechanism than an individual member-per-member response would have been.

With the Russian invasion on Ukraine, not only a breach of international law has been undergone, but also has most of the European gas supply been interrupted. As energy prices increased, the whole supply-chain became costlier. A major increase in inflation has been noticed since February 2022.

According to the International Monetary Fund (IMF), this winter, more than half of the countries in the euro area will experience technical recessions. (IMF, 2022) And while inflation is projected to decline next year, it will stay significantly above central bank objectives of 2 percent, at about 6 percent and 12 percent, respectively, in advanced and emerging European economies. Additionally to the inflation and recession, the budget deficit in some EU countries has been noticeably increased. The highest deficits were recorded in Malta (-8.0%), Greece (-7.4%), Latvia (-7.3%), Italy (-7.2%), Romania (-7.1%), Spain (-6.9%), Hungary (-6.8%), France (-6.5%) and Slovakia (-6.2%). (Trading Economics, 2022)

Conclusion

The paper provided a brief insight into the monetary integration process over the past decades, what has caused it and where we are now.

Contradictory to the expectations prior to the financial crisis 2007/08 where the banking efficiency has been focused on, the paper shows that the establishment of the European banking

and Capital Market Unions have been prioritized, as the banking stability has now gained more weight. The paper did not cover a great piece of the financial crises as this was not the topic – but was mentioned as the course of the integration has been changed due to it.

Due to the unfortunate and unexpected events of the Covid 19 Virus Crisis and the recent Russian-Ukrainian conflict, the Eurozone has entered new challenges. Inflation, Recession and budget deficits are the new tasks on the agenda.

We have seen that the banking efficiency has been improved anyway as the market has become more stabilized. Although the banking market has slightly changed in its composition due to the global environment, it has remained rather stable during the financial and Covid crises. Another trigger however have been the arising energy shortage/inflation crises which are still present – their consequences are still being measured and dealt with in a fiscal policy-amendment matter, proving again the importance of highly stable and functioning institutions.

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