

# European recovery: Perspectives and challenges ahead

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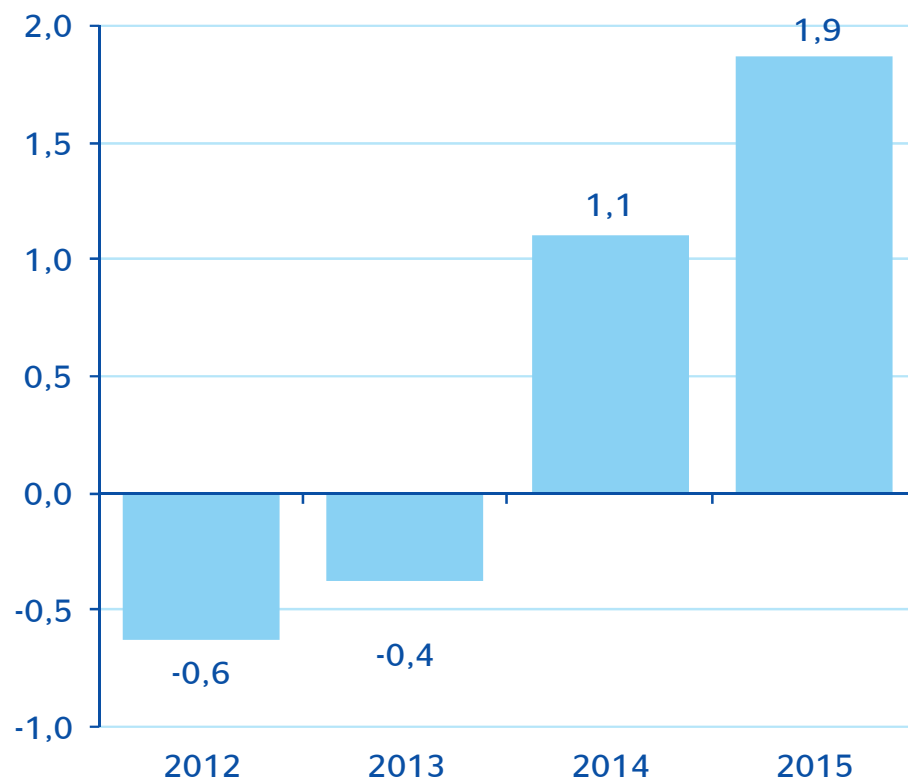
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**"Iberian Conference on European Recovery and Economic Perspectives"**  
Madrid, 12 June 2014

The economic growth has returned to Europe after two years of recession due to better foreign demand, ...

**Eurozone: GDP growth (YoY)**

Source: BBVA Research



■ Baseline Apr-2014

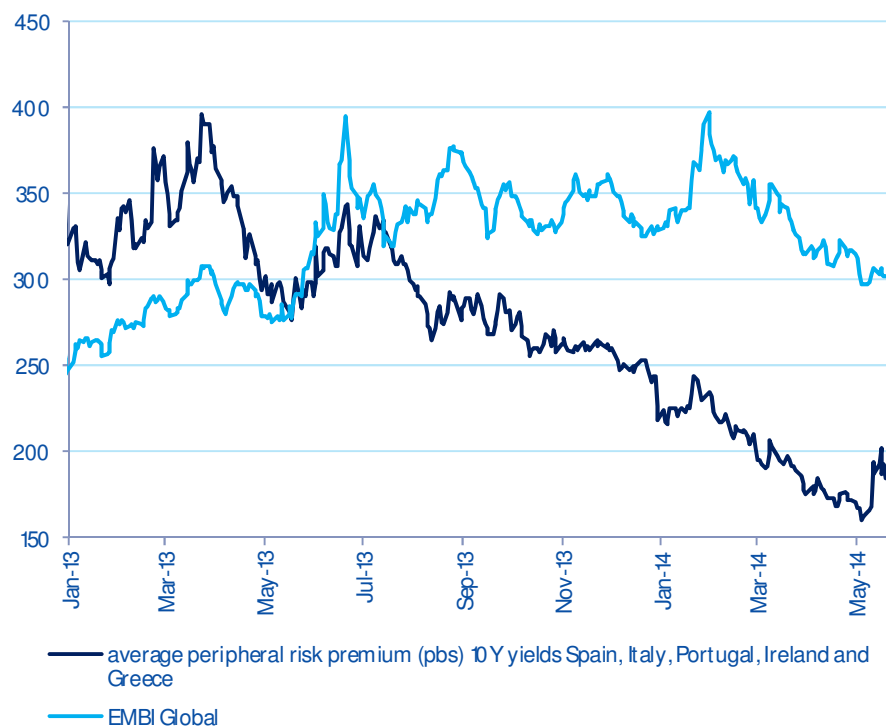
Foreign demand is improving

The slowdown in Emerging Economies and the euro's strength would lessen the positive contribution of the external sector

... the improvement of funding conditions and the moderation in fiscal adjustment

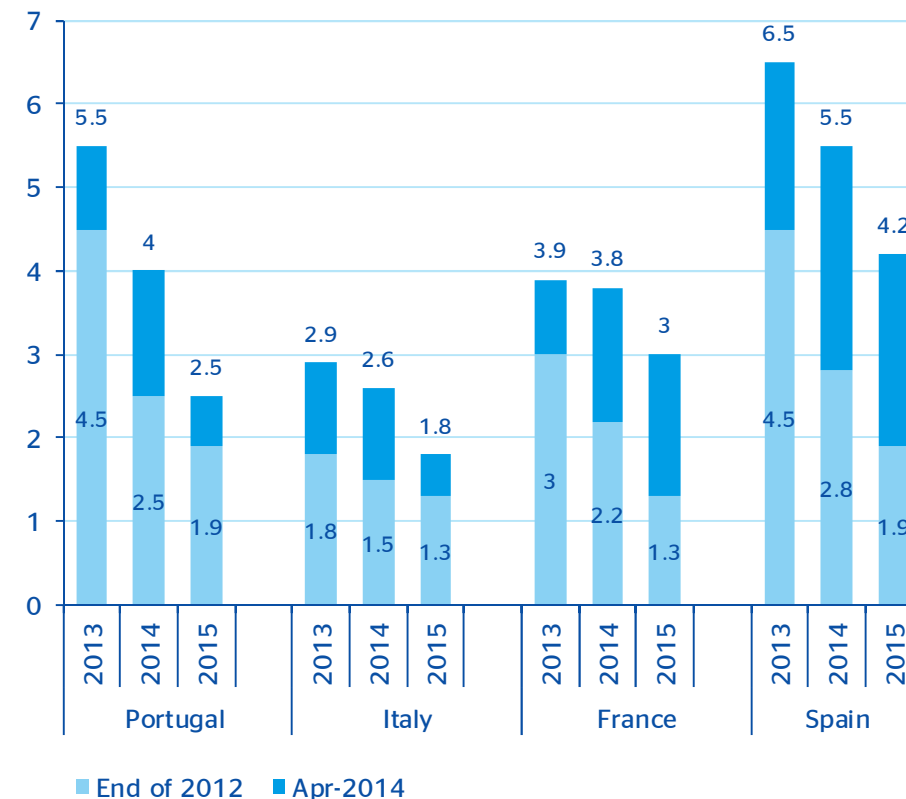
### European peripheral risk and EM risk

Source: Bloomberg and BBVA Research



### Change in public deficit targets

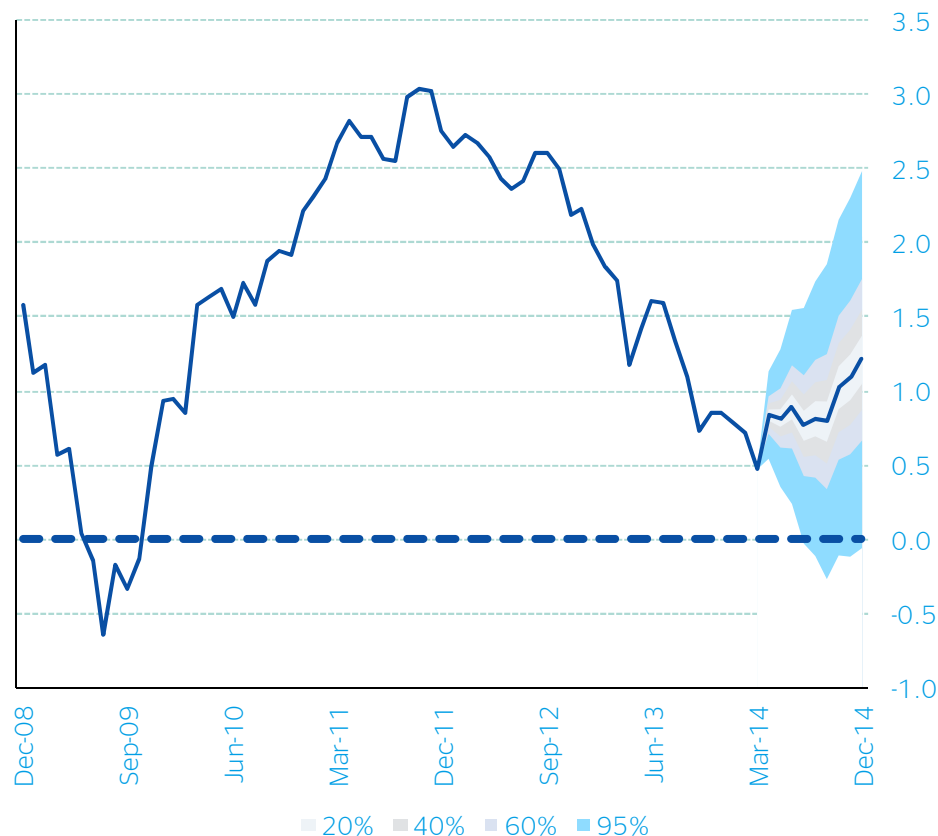
Source: Eurostat and BBVA Research



The cyclical recovery should favor a progressive rise in inflation, well below the ECB's objective, and an improvement of credit flows

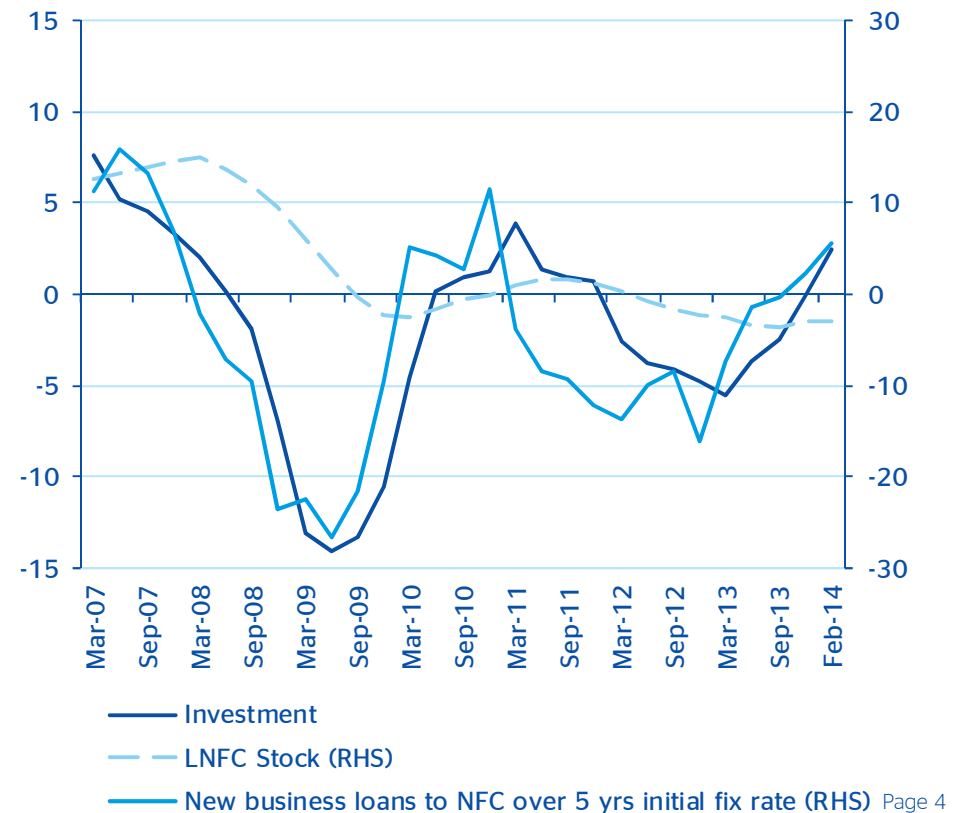
### Inflation in the eurozone: baseline scenario

Source: BBVA Research



### Eurozone: Loans to non-financial corporations and investment (% YoY)

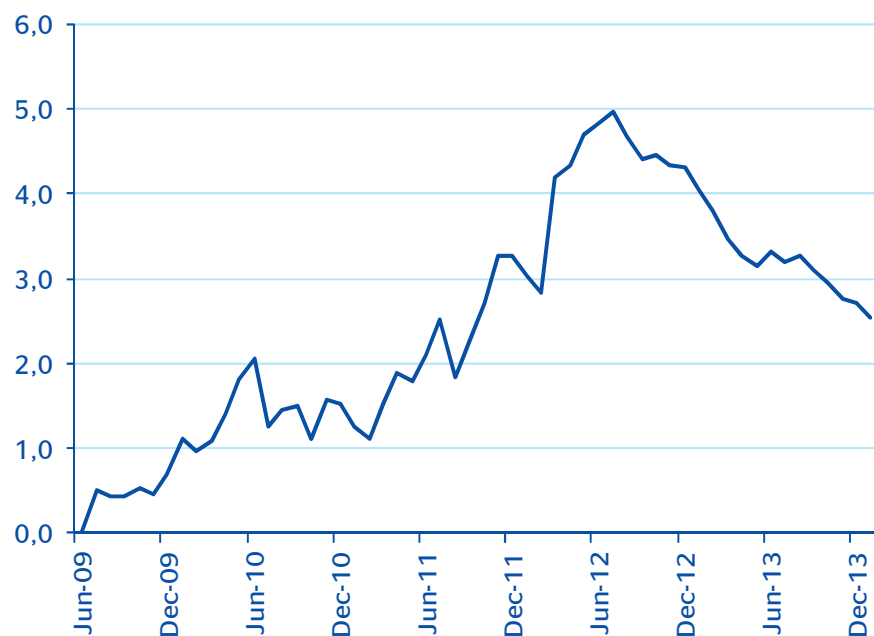
Source: Eurostat and BBVA Research



# However, challenges remain to lessen the fragmentation within the EMU, financial and real

## Composite measure of eurozone financial fragmentation\*

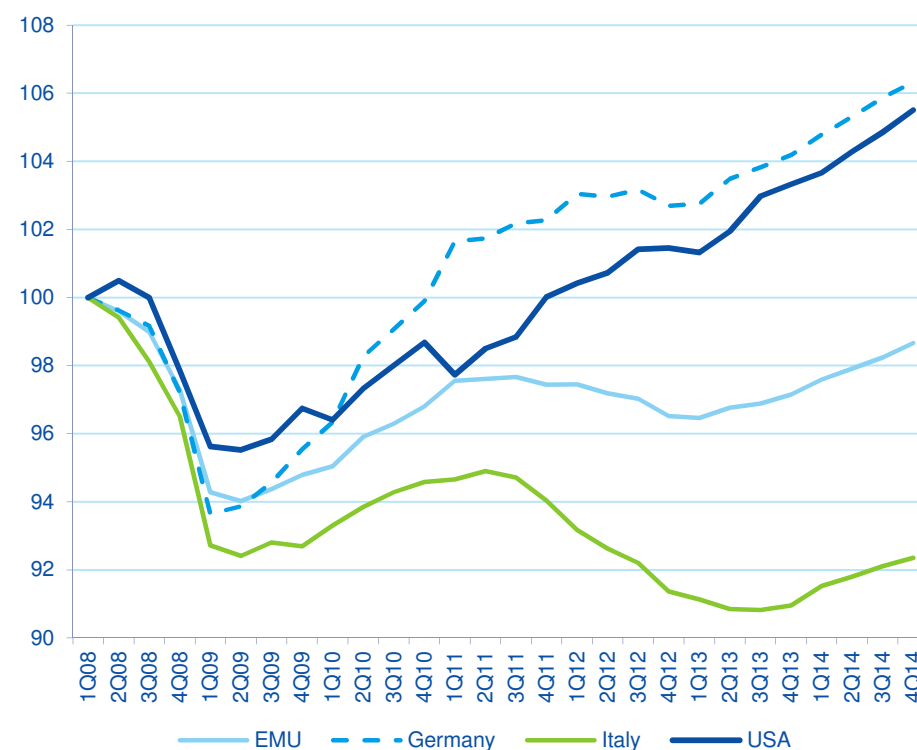
Source: BBVA Research and Bloomberg



\* See Annex for more details

## GDP per working age population 2Q08=100

Source: Eurostat and BBVA Research



# Reaction to the crisis: From firefighting to institutional reform

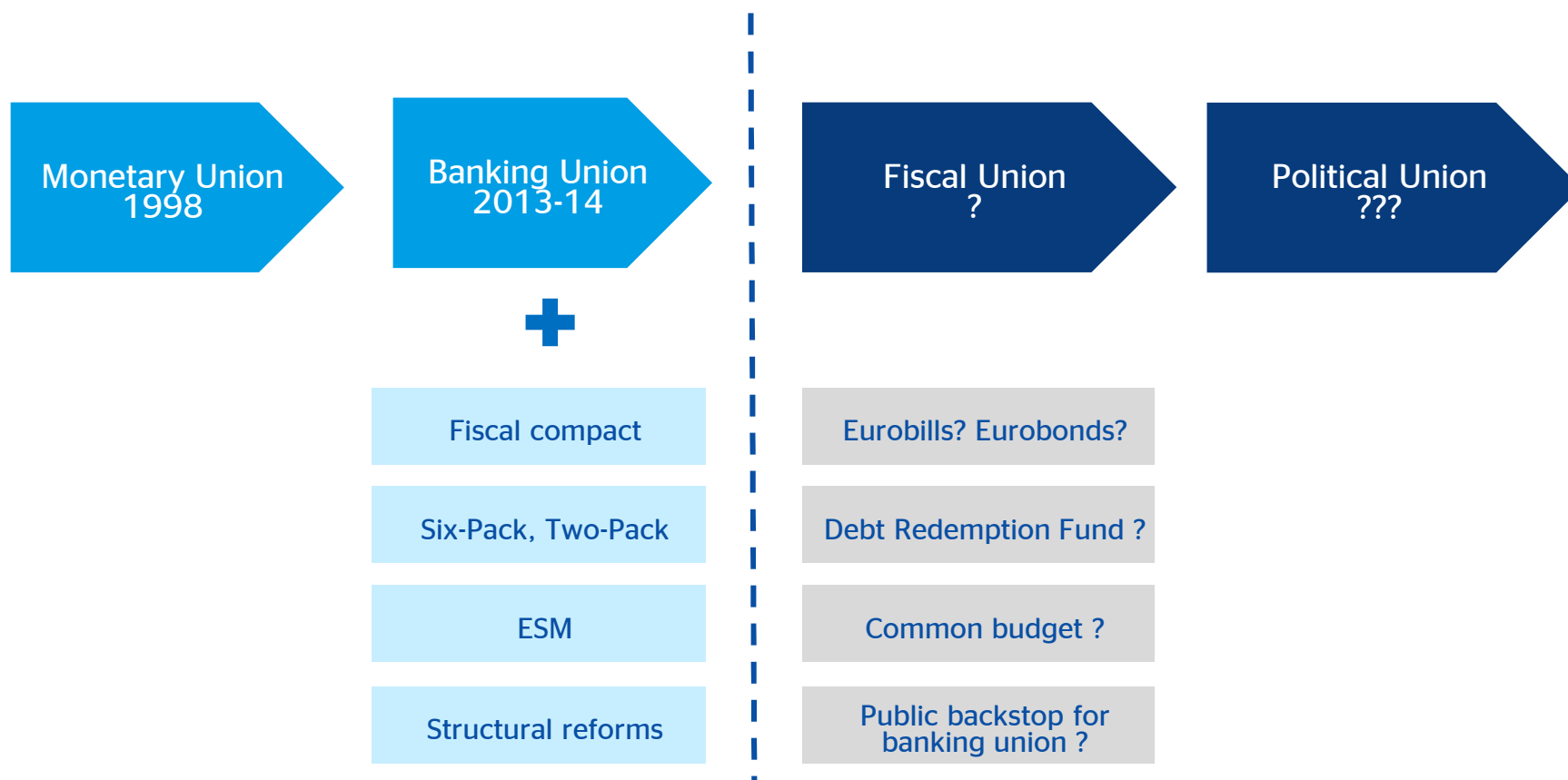
## Challenges

## Response

Public imbalances	Troika programmes, Fiscal compact, Six-pack, Two-Pack
Private debt	Deleveraging, Six-pack, Macro-prudential measures
External imbalances	Structural reforms, Troika programmes
Fragmentation	EFSF, ESM, ECB liquidity provision, Banking Union
Risk of euro redenomination	Banking Union, OMT programme

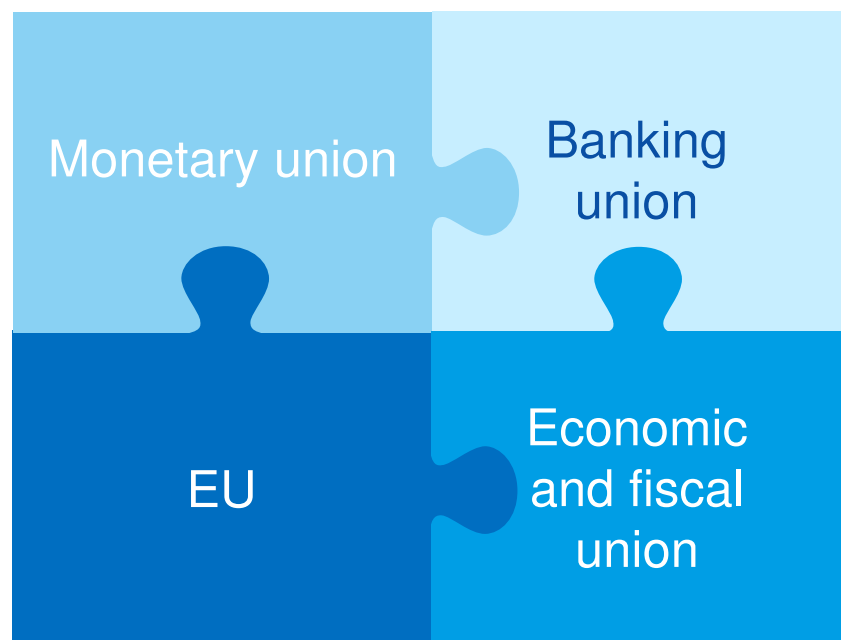
# The new Commission has to decide whether to press for more ambitious and sustainable integration

The two options are to stop and take stock of measures taken so far, or continue with the plan to complement the monetary and banking union with a fiscal union



# Banking union, the greatest transfer of sovereignty since the creation of the euro

A roadmap towards an Economic and Monetary Union 3.0



Economic and  
Monetary Union 3.0

We need a banking union....

To break the vicious circle between banks and the sovereign

To strengthen the institutional architecture of the euro

To restore the single monetary policy and the transmission channel

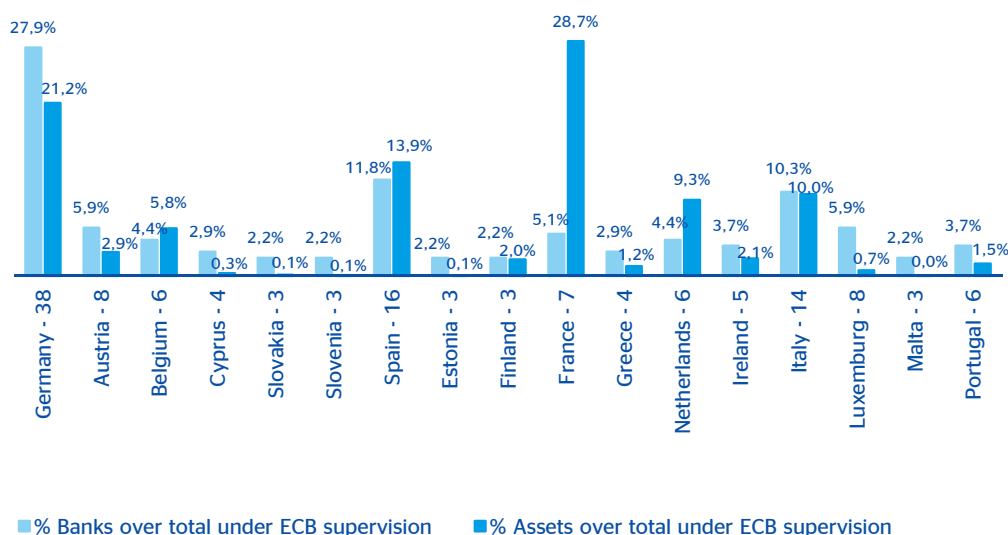
To minimize the cost to the taxpayer



# A single supervisory culture for the Eurozone

Since 04/11, the ECB will become legally responsible for nearly 6.000 banks

## ECB direct supervisory scope, by country



Unifies interpretation and application of the new prudential rules (CRDIV)

Puts an end to national ring-fencing and forbearance in supervisory practices

Increases confidence in the supervision of financial systems

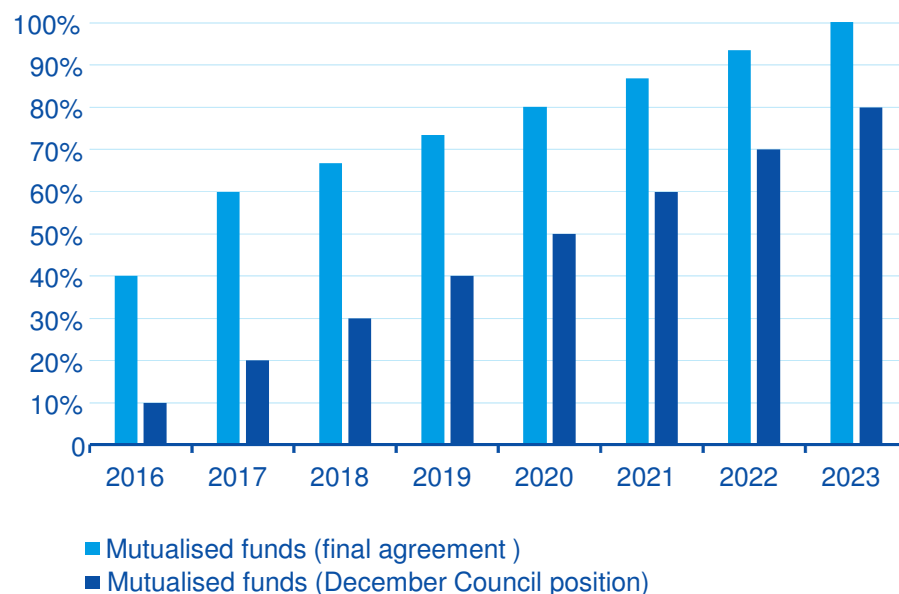
¿Why the ECB? Prestige, independence, knowledge, legal reasons

# Banking resolution at EU level in one weekend

Decision-making at a European authority and financed by private mutualised funds

## Progressive mutualisation of funds

Source: European Commission



Provide the single supervision with a credible counterpart at the same level

Preserve the level playing-field by ensuring a uniform implementation of the EU bank resolution rules (BRRD)

Enhance cross-border resolution processes in the EU

## Banking union and fragmentation: It will take time to break the vicious circle

It has contained and reduced the fragmentation process...

...but it is essential that we complete banking union and we move towards deeper economic, fiscal and political union

This project is not designed to solve the problems of the past, rather those of the future...

... but finding a definitive solution to the legacy problems is a key prerequisite for a sound banking union

The SSM is a game changer for supervisory culture and practice in Europe...

...but will have to maintain a constructive relationship with third countries (host) supervisors and take into consideration the different business models

Under the SRM ailing banks will be resolved over a weekend by a European authority and with recourse to common private funds.

...but the uncertainty on the common public backstop must be urgently dispelled

## Summing up

Economic growth has returned to Europe after two years of recession, due to dynamic foreign demand, improved funding conditions and the lower fiscal adjustment

Challenges remain to lessen the fragmentation within the EMU, financial and real fragmentation. The reinforcement of SGP and the Banking Union are major advances, but they have to be properly implemented

The new Commission has to decide whether to press for more ambitious and sustainable integration

# Europe: better perspectives but challenges ahead

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## Annex: Financial fragmentation index

In order to monitor the financial fragmentation in the euro area, we constructed a composite measure of euro area financial fragmentation. The advantage of utilizing such index is the ability to monitor, on a monthly basis, more accurately the evolution of financial fragmentation.

The FFI is constructed using principal component analysis, a statistical method of extracting factors responsible for the co-movement of several variables. We assume that financial fragmentation is the primary factor influencing this co-movement, and by extracting this factor (the first principal component) we are able to create an index.

The components are:

- the interquartile range of euro area countries\* two-year government bond yields ,
- the cross-country dispersion (specifically, the coefficient of variation: the ratio of the standard deviation to the mean) of bank lending rates to corporates and households (average),
- the gross liquidity provision by the Eurosystem as a share of bank assets, and
- the Target 2 balances surplus.

To combine these varied indicators\*\*, we calculate a Z-score for each, and then estimate the first principal component of these Z-scores.

\* Ireland, Spain, Germany, Italy, France, Netherlands, Portugal, Greece, Belgium, Finland and Austria.

\*\* Data: monthly frequency. Sources: National Central Banks, ECB and Bloomberg

Europe must strengthen the monetary union by reinforcing the institutional architecture



**Fiscal compact:** strengthening the surveillance and correction of fiscal imbalances

**OMT:** ECB's instrument to countering speculative attacks on sovereign

**ESM:** Mechanism to bailout sovereign debt with conditionality

**Banking Union (BU):** agreement of supervision and regulation of the banking system to lessen the dependence from sovereign