Andreas Dombret: Europe's sovereign debt crisis – causes and possible solutions

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, to the Deutsche Alumni, Frankfurt am Main, 20 December 2011.

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Ladies and Gentlemen

Thank you very much for inviting me to speak to the Deutsche Alumni here today. The second half of 2011 has certainly not been the best of times for the euro area and for financial stability.

The financial crisis has now entered into a fourth stage. The first stage was the subprime crisis which struck the US real estate market. At its heart were those financial products which spread US housing loans across the world. The second stage was the loss of confidence within the international financial system following the Lehman Brothers bankruptcy and the subsequent global economic crisis. The third stage has been the ongoing European sovereign debt crisis which began in Greece in May 2010. It was initially perceived as a problem of what was known as the "euro-area periphery". Now, in the fourth stage of the financial crisis, however, this designation no longer holds.

How things now stand

The sovereign debt crisis has now spread to the core of the euro area. This has affected the funding conditions for governments and banks alike. The European financial system faces a serious loss of confidence.

Against this background, the risks to the German financial system have risen perceptibly as well. And yet, since the beginning of 2009, the German financial system has become much more resilient. Banks have more – and better-quality – capital. Domestic credit risk is at its lowest level in three years. Funding vulnerabilities have also been reduced. Customer deposits, regarded as a stable source of funding for banks, have gone up markedly.

However, the high sovereign debt, part of which is on banks' books, now poses a significant risk to financial stability – one that not even Germany's financial system can avoid. This is made particularly clear by the latest *Financial Stability Review* published on 10 November by the Bundesbank.

The sovereign debt crisis, though, has not only hit the financial system, but is also increasingly impacting negatively on the real economy. Although the corporate sector has still been assessing the economic situation in Germany positively, it expects the situation to deteriorate in the future. Hard indicators are showing a similar picture: exports, for instance, went down distinctly in October, which will put a damper on economic output. On the whole, the Bundesbank, in its current forecast for 2012, is expecting Germany's economy to grow by 0.6%.

However, since the domestic factors for an upswing remain intact, we expect Germany to turn onto a recovery path before the end of next year. Supported by an expansionary monetary policy and a growing global economy, growth in 2013 should then return to 1.8%. This means that, in the next two years, the German economy's capacity utilisation would therefore be normal. A probable average increase of 2.5% for this year is likely to be followed by a return to a much lower cost of living in the coming two years, which the Bundesbank currently expects to be 1.8% in 2012 and 1.5% in 2013.

This forecast, of course, is based on the assumption that the sovereign debt crisis will be gradually overcome and will not continue to escalate. This crisis is, and will remain, the single greatest risk to the financial system and the real economy.

For this reason, I would now like to take a closer look at the sovereign debt crisis, focusing on three questions. *First*, what actually caused the crisis? *Second*, how do we contain the crisis? *Third*, where do we want to go with monetary union in the long run?

The causes of the sovereign debt crisis

Unsound economic developments had apparently been brewing in several euro-area countries for many years. These include, in particular, excessive lending, asset price bubbles and a loss of competitiveness. These structural deficits were the breeding ground for the sovereign debt crisis.

The actual weak link at the launch of monetary union, however, was the combination of a single monetary policy and decentralised fiscal policy. Monetary policy is set at the European level – by the European Central Bank. By contrast, responsibility for fiscal policy rests with the individual member states, ie at national level. This severance of responsibilities was already at the centre of the debate when monetary union was being established. In a currency area with a decentralised fiscal policy, the member states have an increased incentive to borrow. Any country that goes deeper into debt does not face the consequences by itself, as these are spread across the entire currency area – for example, through every country's interest rates increasing.

The founding fathers of monetary union therefore created a framework of rules to prevent, or at least correct, such unsound developments: the Stability and Growth Pact. This was intended to keep national fiscal policies in check. One of its tenets was that annual government budget deficits should not exceed 3% of gross domestic product. A complex procedure was performed regularly to monitor member states' compliance with this limit. The penalties for breaching the deficit limit could be escalated all the way to financial sanctions.

There is one more key building block in the edifice of the euro area alongside the Stability and Growth Pact: the no-bail-out principle, which forbids member states from assuming liability for the debts of other member states. The guiding principle of monetary union was therefore individual responsibility: member states' individual responsibility for the consequences of their policies and financial market agents' individual responsibility for the consequences of their investment decisions.

Despite these rules, however, member states' borrowing has not been effectively contained. Why not? Mainly, because the rules of the Stability and Growth Pact were not only circumvented but even bent. This was possible thanks to a crucial flaw in the system: countries that violated the deficit limit were not automatically punished. Instead, the other member states voted on a sanction. And this – to quote the ECB's former chief economist Otmar Issing, led to a situation in which sinners passed judgement on fellow sinners. This, of course, encouraged a "you scratch my back and I'll scratch yours". Put differently: "I won't punish you today if you don't punish me tomorrow."

Looking back, it must also be noted that the financial markets did not have the desired disciplining effect on fiscal policy. Investors turned a blind eye to the misbehaviour of some member states for far too long. By the time the interest rates on government bonds started to rise, the horse – in this case, the Greek minotaur – had already bolted.

And, once the horse has bolted, the no-bail-out principle is gone with it. As I'm sure you will remember, no member state is allowed to assume liability for another's debts. This principle was, at the very least, stretched quite far when assistance was granted to Greece. This, however, was not entirely unjustified: the euro-area countries are now so closely integrated that problems in one country can spread quickly to envelop the entire euro area, in a phenomenon known as contagion. When push came to shove, it was deemed necessary to help other member states. This is quite understandable in the short term. However, in the long run it is dangerous if countries with a debt problem can expect to receive help no matter what. This can raise the spectre of a dangerous spiral of more and more assistance and less and less confidence in the will of the affected countries to amend their ways.

Routes to a stable monetary union

And such a loss of confidence is just what we are facing right now. The public, and also the markets, have lost faith – in politics, but also in the architecture of monetary union. The question is: how do we go about restoring confidence?

Let me begin by stating clearly what won't work. Confidence cannot be sustainably restored by putting more and more money on the table – for instance, by constantly ramping up the rescue funds. This strategy ultimately has its limits – be they political or financial. And the proposal of circumventing financial limits by switching on the printing presses is dangerous. Of course the resources of a central bank are, in theory, nearly limitless. Using them to finance sovereign debt, however, does not solve problems but instead creates new ones. Such an approach would endanger the key foundation of a stable currency: the independence of a central bank that is dedicated to price stability. This would throw overboard the very things that need saving.

And, as I said earlier: money can't buy you confidence. The only thing that can be bought is time. With the EFSF and the forthcoming ESM, instruments to do just that have been created. However, this bought time must also be used to eliminate the root causes of the crisis. From this we can derive three main things that, in my opinion, need to be achieved.

Firstly, government budgets need to be put back in order. This goes for all euro-area countries, but is particularly incumbent on those countries which have time and again put off the necessary adjustments. Efforts are apparently being made at the political level to step up pressure from other member states and the European Commission.

Secondly, the countries affected by the crisis need to conduct structural reforms in order to become more competitive and to promote economic growth. Such reforms are, naturally, difficult and painful. The Irish case shows, however, that they are possible, and the German case shows that they pay off in the long run.

And, *thirdly*, we need a stable architecture for monetary union. Instead of constantly patching up the results of fiscal policy mistakes and insufficient implementation of the Stability and Growth Pact, monetary union has to be "reinvented" – such that sound fiscal policy is also truly guaranteed in future. In my view, there are two options open to the euro area: either we can return to the founding principles of monetary union agreed at Maastricht, or we should venture the step towards a deeper European integration which also includes fiscal policy.

Returning to the founding principles of monetary union

Regarding the first option – returning to the founding principles of monetary union – I do not share the frequently voiced fear that the current framework is unsuited to monetary union. However, it clearly needs adjustment, of course. There are three key points here.

Firstly, the Stability and Growth Pact must be given "teeth". In particular, a stronger automatism is needed to punish breaches of the deficit and debt limits.

Secondly, the no-bail-out principle needs to be reinforced: no member state should be permitted to assume liability for the debt of another member state. Financial market investors will only punish bad fiscal policy behaviour in a timely manner if they expect to lose their money.

Thirdly, the euro area needs a permanent crisis mechanism. Recourse could be taken to this mechanism if a crisis erupts and financial stability throughout the euro area is at risk. However, there are three important aspects to note: assistance to individual countries must be tied to strict economic and fiscal policy conditionality; it must be only granted with appropriate interest rate premiums; and, in the event of a default, private-sector investors have to bear their losses themselves.

In view of these exigencies, some encouraging decisions were taken at the EU summit on 8 and 9 December. They included the introduction of debt brakes which should be firmly enshrined in national law. At the same time, the Stability and Growth Pact is likely to be better protected from political influence in the future. If a country violates the pre-defined deficit limit, it will, unlike in the past, be automatically punished; it will be much more difficult to avoid sanctions. That, too, is an improvement. And – depending on the design and implementation – this could represent a major step towards a "Maastricht Plus" model. However, it is only a small step towards deeper European integration – I will come back to this point shortly. By no means, however, is this a fiscal union in the narrow sense of the term. The important thing now, naturally, is not to allow the agreements made to be watered down – either in the specific arrangements or their subsequent application.

Deepening European integration

Besides strengthening the existing framework of monetary union, there is an alternative route to stabilising the euro area. This route would involve deepening European integration. However, it would not necessarily also mean the wholesale transfer of fiscal policy from national to European level. National parliaments could retain their independence in deciding on revenue and spending; European involvement would only affect borrowing and indebtedness. What kind of involvement could this be?

It would be important to set strict deficit and debt limits at the European level for national budgets. These limits would apply at all national levels; in Germany, this would encompass central, regional and local government, as well as the social security systems. The European rules would have to be combined with appropriately strict powers of intervention, as this is the only way to make them enforceable. One thing ought to be made clear: member states that do not comply with the predefined deficit and debt limits would lose their fiscal policy sovereignty. Ultimate budget-setting authority would therefore no longer rest with national parliaments but at the European level.

The EU summit decisions, however, still do not give Europe the right to take over national fiscal policy in the event of persistent fiscal policy misbehaviour. If, for instance, Eurobonds were to be issued in such a framework, there would be a mismatch between liability and control: all euro-area countries would be jointly liable for the debts of other euro-area countries but would not be able to keep them in check. In this framework, mutual assistance must be granted only as a last resort, must be strictly conditional and must involve considerable interest rate premiums, in order to give countries an incentive to balance their government budgets.

Financial market reform as a necessary addition

National fiscal policymakers are ultimately also responsible for convincing market participants to invest in their sovereign bonds. The recent past has served at a painful reminder that berths at the "safe haven" of sovereign bonds have to be defended time and again. This is also true of Germany. The auction of ten-year Bunds at the end of November, failed to attract sufficient bids despite all-time low interest rates, may very well be interpreted as a shot across the bow, yet its importance should definitely not be overrated.

In addition, rating agencies have issued warnings, with Germany no longer being left out. The timing of some of these announcements is certainly debatable – and, in my opinion, often questionable. However, this should not divert our attention from the responsibilities of fiscal policymakers. Introducing, through regulatory measures, special rules for developing sovereign bond ratings does not seem a particularly appropriate solution, at any rate. Instead, we should reduce references to ratings in regulations wherever possible.

I should also mention that significant progress has already been made in the area of financial market regulation, too. Given the fact that regulatory flaws were among the main causes of the financial crisis, this was, in my opinion, of paramount importance. The reform of the capital framework, which will improve the quantity and quality of banks' capital and thus their capacity to absorb losses, is certainly a particularly welcome development. Increasing the amount of losses the banks' investors are able, and required, to bear, reduces the danger of taxpayers once again having to foot the bill. The phenomenon of systemically important banks, meanwhile, shows that Basel III is by no means the end of the road. The internationally agreed rules for dealing with the "too-big-to-fail" issue now have to be rapidly implemented at national level in an internationally consistent manner. The complex oversight and, if necessary, regulatory treatment of the shadow banking system remain atop the reform agenda. Although the current zero weighting of government bonds likewise sets the wrong incentives, it should only be adjusted going forward, predicated on precise studies.

Looking at the financial markets and their regulation, however, I would like to mention one more thing. The sovereign debt crisis is shining a new light on a commonly held assumption, namely, that crises are caused by unfettered markets and can be avoided only by giving the state more space. However, the sovereign debt crisis has shown quite clearly that even states are fallible.

Of course, the crisis has opened our eyes to the blind faith in the market that has sometimes prevailed; however, statism and dirigisme are by no means the right path to take. Instead, we should return to a founding tenet of the social market economy: individual responsibility. Those who take risks must also face the consequences. Reviving attaching more importance to this principle this would represent major progress – including with respect to the sovereign debt crisis.

Conclusion

Ladies and gentlemen, I have touched upon various aspects which I think are essential for resolving the sovereign debt crisis. At the EU summit in early December, policymakers decided to adopt a fiscal pact designed to strengthen, and in some cases go beyond, the Maastricht Stability and Growth Pact. This is a good first step; however, it must not be watered down once again during its concrete implementation. The Bundesbank will not cease to call for this concrete implementation.