Andreas Dombret: New year, old problems – Europe's sovereign debt crisis

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, to the International Bankers' Club, Luxembourg, 6 February 2012.

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1 Introduction

Ladies and Gentlemen

Thank you very much for your invitation. I am delighted to have the opportunity to speak to you today at the International Bankers' Club. As you will know the central banks of Luxembourg and Germany work closely together and exchange views regularly – this is why I am here today. Even at the start of a new year, we are still facing the same old problems: we are battling a crisis which is now in its fifth year and has reached its 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 the risks stemming from US housing loans all over the world. The loss of confidence within the international financial system following the Lehman Brothers bankruptcy and the subsequent global economic crisis mark the second stage. The third stage has been the ongoing European sovereign debt crisis, which became visible to the whole world in Greece in May 2010. It was initially perceived as a problem of what is known as the "euro-area periphery". Now, in the fourth stage of the financial crisis, however, it is no longer limited to these countries.

The sovereign debt crisis, unfortunately, has now spread to the core of the euro area. This was made painfully clear to us once again in the middle of last month. On the 13th of January, Standard & Poor's downgraded nine euro-area countries. However, I do not want to join the chorus of criticism against the rating agencies. Those who would pin the blame on the agencies are confusing cause and effect. The agencies are merely the bearers of bad news, and "shooting the messenger" is not only unfair – it does not solve the problem, either.

I would therefore like to take a closer look at the causes of the bad news which has been hitting us in waves since the outbreak of the sovereign debt crisis. There are three questions I would like to examine more closely. *Firstly*, what actually caused the crisis? *Secondly*, how do we contain the crisis? *Thirdly*, where do we want to go with our monetary union in the long run?

2 The causes of the sovereign debt crisis

Severely unhealthy economic developments had apparently been brewing in several euro-area countries for many years. These included, most notably, excessive lending, asset price bubbles and a loss of competitiveness. These structural problems were the breeding ground for the sovereign debt crisis.

The actual weak link at the launch of our monetary union, however, was the combination of a single monetary policy and a decentralised fiscal policy. Monetary policy, as you know, is set at the European level – by the European Central Bank. On the other hand, responsibility for fiscal policy rests with the individual member states, i.e. at national level. However, in a currency area where fiscal policy is decentralised, the member states have a relatively large incentive to borrow. If a country accumulates more and more debt, it does not face the consequences by itself as these are spread across the entire currency area – for example, through rising interest rates.

The founding fathers of our 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 may not exceed 3% of gross domestic product. The penalties for breaching this 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 stretched to its limit. 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. This, of course, encouraged an attitude of "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 exert 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 damage had already been done.

And, faced with that situation, it is extremely difficult to uphold the no-bail-out principle. 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 a long way when assistance was granted to Greece. That, however, was not entirely unjustified: the euro-area countries are now so closely integrated that problems in one country can spread quickly to the entire euro area in a phenomenon known as contagion. When push came to shove, it appeared necessary to help other member states. And that 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 risks triggering a dangerous spiral of more and more assistance and less and less confidence in the will of the affected countries to mend their ways.

3 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 our monetary union. The question is: how do we go about restoring confidence?

Let me begin by stating clearly what won't work. Setting up larger and larger rescue packages is not the way to instil lasting confidence. This strategy ultimately has its limits – be they political or financial. And the proposal of circumventing financial limits by printing money is dangerous. Of course the resources of a central bank are, in theory, nearly without limit. 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 dedicated to price stability. This would throw overboard the very things that need saving.

And, as I said earlier: money can't buy confidence. Even the largest rescue packages can provide no more than a temporary reprieve. Time, in fact, is the only thing you can buy. But this bought time must actually be used to eliminate the root causes of the crisis. And this leads us to three key steps that the Bundesbank believes need to be taken.

Firstly, government budgets need to be put back in order. This goes for all euro-area countries but is particularly the case for those countries which have put off the necessary adjustments time and again. This is where the critics jump in to say that excessive saving damages economic growth. However, I think this is too short-sighted. Of course fiscal consolidation normally dampens economic activity. But there is no way the present situation can be described as "normal"! In fact, doubts about the sustainability of government finances are probably themselves a considerable drag on growth. The critics are right about one thing, though: consolidation alone is not enough to solve the problems we are facing.

Secondly, the countries affected by the crisis therefore need to conduct structural reforms in order to become more competitive and to promote economic growth. Such reforms are, naturally, difficult and painful. Ireland has shown, however, that they are possible, and the German experience has proven that they pay off in the long run.

And, *thirdly*, we need a stable architecture for our monetary union. Instead of constantly patching up the results of fiscal policy mistakes and insufficient implementation of the Stability and Growth Pact, the framework of monetary union has to be changed in a way 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.

3.1 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. Nevertheless, it does require considerable adjustment. There are three key points here.

Firstly, the Stability and Growth Pact needs to be given "teeth". In particular, stronger automatism is needed to penalize 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 promptly 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 only be granted with appropriate interest rate premiums, and private-sector investors have to bear their losses themselves in the event of a default.

In view of these pressing needs, a "fiscal compact" was agreed upon at the EU summit last week. This compact includes the introduction of debt brakes which should be firmly enshrined in national law. At the same time, the Stability and Growth Pact will be enhanced to be better protected from political influence in the future. Whether these decisions represent a major step forward remains to be seen. As happened before, the initial agreements seem to have been watered down during the negotiation process. The rules regarding the debt brakes leave significant room for interpretation, and their application and enforcement will not be monitored at the European level. It seems that the new version of the Stability and Growth Pact might not be followed too strictly at the European level, either. Altogether, the latest decisions are not entirely convincing.

3.2 Deepening European integration

Besides strengthening the existing framework of monetary union, there is an alternative route to stabilising the euro area. This 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 if limits are breached. So what form could this involvement take?

It would be important to set strict deficit and debt limits at the European level for national budgets. These limits would then apply at all national levels. In Germany, for example, this includes federal, state and local government and the social security systems. The European rules would have to be combined with strict powers of intervention as this is the only way to make them enforceable.

But it has to be crystal-clear: any member state in breach of the predefined deficit and debt limits would lose its fiscal policy sovereignty. Ultimate budget-setting authority would therefore no longer rest with national parliaments but at the European level.

In this area, however, the latest EU summits have made little headway. The adopted "fiscal compact" does not provide for intervention in national fiscal policy even if a country repeatedly breaches the rules. This means the "fiscal compact" is not the same as a true "fiscal union". If, for instance, Eurobonds were to be issued now, 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. However, 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.

3.3 Financial market reform as a necessary addition

National fiscal policymakers are ultimately responsible for convincing market participants to invest in their sovereign bonds. The recent past has served as a painful reminder that the status of sovereign bonds as a de facto risk-free asset has to be defended time and again. And rightly so: the only way to get governments to live within their means is if the financial markets reward good fiscal policy and punish bad fiscal policy.

However, in order to have a disciplining effect, the financial markets need a firm set of rules – as was made abundantly clear by the crisis. And significant progress has already been made in adapting the rules. 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 take, reduces the danger of taxpayers once again having to foot the bill. The phenomenon of systemically important banks, however, also shows that Basel III is by no means the final step. The internationally agreed rules for dealing with the "too-big-to-fail" issue now have to be implemented quickly – and in an internationally consistent manner. The oversight and, if necessary, regulation of the shadow banking system remain atop the reform agenda.

The laundry list of regulatory reforms continues to be very long, and its details are often so complex that it is difficult to explain to the general public. This opens the door to populist calls for seemingly simple solutions – such as a financial transactions tax. We at the Bundesbank are of the view that, if at all, such a tax would have to be introduced at least in all major financial centres.

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 sovereign debtors can fail.

Of course, the crisis has opened our eyes to a blind faith in the market that has sometimes prevailed; however, statism and dirigism are, by no means, the right path to take. Instead, I suggest we return to a founding tenet of the social market economy: individual responsibility.

Those who take risks must also face the consequences. Attaching more importance to reviving this principle would represent major progress – including with respect to the sovereign debt crisis.

4 Conclusion

Ladies and gentlemen, dear members of the International Bankers' Club, I have touched upon various aspects which I believe to be essential for overcoming the sovereign debt crisis. At the EU summit last week, policymakers decided to adopt a "fiscal compact" designed to strengthen, and in some cases go beyond, the Maastricht Stability and Growth Pact. This is, in principle, a good first step, but it has yet to prove its usefulness and effectiveness in "everyday use". In any case, the Bundesbank will not cease to call for the compact to be implemented in a manner which is conducive to safeguarding stability. In this endeavour, we hope for your support.

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