Andreas Dombret: The present state of the euro-area sovereign debt crisis

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bank of America Merrill Lynch Global Macro Conference, London, 12 June 2012.

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1. Introduction

Having joined the Board of the Bundesbank only two years ago after a long career in banking, I am, once again, delighted to address senior market participants. I am acutely aware of the importance to exchange information on the euro-area sovereign debt crisis not only among central bankers and policymakers but also with the markets.

First of all, before commenting on the sovereign debt crisis, I would like to remind you of a success story. More than 330 million people in the euro area are benefiting today from a single currency, which was introduced in 1999. The euro is not only our most visible symbol of European integration. While the motivation for its introduction was predominantly political, the euro has been a success in economic terms, too. Since its introduction, its internal value has been at least as stable as the earlier national currencies. The average inflation rate has stood at 2%. I call this a true success.

That is all well and good, you may say, but some of you may be wondering whether such a positive verdict has not been refuted by the most recent upheavals in the euro area. Indeed, some investors are sceptical about the euro, and more than just a few are predicting the break-up of the currency union, or at least the departure of individual member states.

In plain language, the central question in my remarks today is “Can the euro make it, and how?” The answer to the first part of this question is crystal clear: “Yes, it can and it will.” To answer the “how”, I shall proceed in two stages: first, by explaining how the crisis came about and, second, by describing Europe’s response so far and, to our mind, future actions needed.

2. Analysis of the crisis

There is no doubt that the euro-area sovereign debt crisis, which was triggered by the global financial and economic crisis, has been the greatest challenge ever faced by European Monetary Union. The European Monetary Union is certainly at a crossroads. The more pressing question, though, is what European Monetary Union will look like over the medium to long term. Will monetary policy, for example, be able to deliver price stability as it did in the past? And how should it be organised in order to do so?

When it comes to solving the current crisis, it is essential to take account of the root causes as well as of the particular features of European Monetary Union.

The root causes of the crisis are well known by now, so I shall be brief on this.

The convergence of long-term interest rates at low levels attracted large capital flows to the peripheral countries of the euro area. Yet, those member states failed in many respects to put these funds to productive use. Instead, they spent the cheap money on public or private consumption – as in Greece and Portugal – or they allowed their residential construction sectors to boom, which eventually led to oversized and vulnerable banking sectors – as in Ireland and Spain. Sharp reversals of credit booms or persistent losses in competitiveness can very easily put the solvency of governments at risk – which is exactly what happened.

And this is of particular relevance in a monetary union, since member states are no longer capable to offset losses in competitiveness by devaluing their exchange rates. Higher-than-average rises in unit labour costs therefore require internal and often painful adjustments in order to regain price competitiveness in international goods and services markets. In a nutshell, several member states failed to meet the requirements of European Monetary Union membership. They did not implement the necessary adjustments.

The inherent risk of monetary union was recognised right from the outset, however. Specifically, the combination of a single monetary policy with national fiscal policies distinguishes the euro area from federal republics like the United States or unitary countries like the United Kingdom. This setup increases the deficit bias and implies the incentive to take advantage of central bank balance sheets to mutualise sovereign debt in one way or another among the taxpayers of different nations.

The founding fathers of European Monetary Union had these disincentives very much in mind when they agreed on the institutional arrangements. First of all, the eurosystem was mandated with a single primary objective, namely maintaining price stability in the euro area as a whole. Moreover, the no bail-out principle, the prohibition of monetary state financing by the eurosystem, and the fiscal rules of the Stability and Growth Pact were all put in place to prevent idleness on the part of member states.

Nevertheless, the crisis also made obvious the shortcomings of the institutional framework of European Monetary Union. The set of rules did not prevent the member states from making the errors I mentioned. Implementation of the fiscal rules was too lax. Moreover, the fiscal rules of the Stability and Growth Pact were, in effect, relaxed some two years before the financial crisis broke out in 2007, following a strident campaign by Germany and France to make the pact "smarter". Furthermore, the designers of the framework turned a blind eye to the emergence of macroeconomic imbalances and their risks to fiscal sustainability as well as to financial stability.

3. Europe's response to the crisis

3.1 Crisis resolution in the short run

Euro-area fiscal and monetary policymakers have taken extraordinary measures to contain the crisis and maintain financial stability. First of all, the euro-area member states and the IMF supported Greece with bilateral loans. Then, a temporary stabilisation mechanism was established, the EFSF. As you know, its beneficiaries have been Ireland, Portugal and, including a second adjustment programme, Greece. Over the course of the sovereign debt crisis, the effective lending volume of the EFSF has been increased, the lending conditions have been relaxed, and the toolbox of the EFSF has been extended. A permanent mechanism, the ESM, with a more resilient funding structure, has been established; it is scheduled to replace the EFSF in summer of this year and to operate temporarily alongside the EFSF. Recently, the euro-area finance ministers agreed to raise the ceiling for combined ESM and EFSF lending to €700 billion. Moreover, the IMF member countries pledged over $430 billion in new loans to the Fund in order to erect a global firewall.

The European and global firewalls alike have been substantially strengthened over the past two years. Are their levels now sufficient? Or should European leaders increase their volume even further?

My opinion in this regard is that policymakers should refrain from a wild goose chase in pursuit of ever higher firewalls. Making the firewalls higher and higher will not resolve the crisis. Instead, policymakers should care that firewalls do not fall into a credibility trap owing to unavoidable political or financial constraints.

Generally speaking, a firewall cannot extinguish a fire. It only buys time until sustainable measures become effective. Therefore, the fire has to be extinguished by other means.

Monetary policy cannot extinguish the fire either. This is not to deny that the monetary policy of the eurosystem has helped to stabilise the financial system of the euro area and beyond. Our policy stance remains rather accommodative. In effect, monetary policy is more expansive than the key interest rate of 1% might suggest. Owing to excess liquidity, market rates are well below that margin. The large excess liquidity results from the non-standard policy measures of the eurosystem. These include an extended list of eligible collateral, the full allotment policy and the provision of very long-term refinancing operations with maturities of up to three years. The Securities Markets Programme and the Covered Bond Purchasing Programme are additional non-standard eurosystem measures. All these measures, I wish to emphasise, are temporary in nature.

The recent setback in equity and credit markets, along with still strong flight-to-safety and flight-to-liquidity flows in sovereign bonds, are mainly the result of political uncertainty in Europe. This reminds European governments that they cannot afford to ease off in their reform and consolidation efforts.

But let me also point to the inherent risks and side effects of the central bank measures. Over the medium to long term, continued provision of ample liquidity might, through various channels, de-anchor inflation expectations, which would translate into higher inflation risks. It could also pave the way for new asset bubbles, thereby sowing the seeds of the next crisis.

Pointing out the risks and side effects of crisis measures does not imply that the Bundesbank wishes to obstruct the stabilisation of the euro. Quite the opposite. We are aiming to strengthen the framework of the euro and to ensure that we continue to have a stable euro in the future. Recurring suggestions to the contrary, for example by George Soros, are therefore ill-advised.

A disintegration of the currency union would be linked to extremely high costs and risks. That's why such a scenario cannot be anyone's goal. Yet this does not imply that Germany becomes open to blackmail and promises guarantees without control. This would indeed erode the stability basis of the currency union.

Some argue, of course, that the eurosystem needs to do whatever it takes to maintain the euro – particularly those who consider the ECB and the national central banks to be the "last men standing". However, it should be borne in mind that it makes a substantial difference whether a non-monetary union central bank – such as the Fed or the Bank of England – or the eurosystem uses its balance sheet as a policy instrument. In the latter case, balance-sheet policies and the implicit risk of losses would imply a shift of burdens among the taxpayers of different member states. But since it is taxpayers' money, it is up to national parliaments and not central banks to decide on such a shift.

Hence, monetary policy must not sacrifice its stability orientation and its credibility in fighting inflation, the more so as monetary policy cannot resolve the crisis anyway. Addressing the sovereign debt crisis is and remains, first and foremost, a fiscal policy task.

Nevertheless, the fiscal and economic policy reforms needed to bring about a lasting solution are, in the short run, costly – both politically and economically. Therefore, a major challenge for monetary policy is that its unconventional measures and the temporary relief they afford are not seen as an excuse to delay, or even reverse, these reforms. Otherwise, monetary policy risks being taken hostage by fiscal policy. This would do lasting damage – to central banks' credibility, to their ability to maintain price stability, and to public acceptance of monetary union as a whole.

3.2 Sustainable crisis resolution

But what fiscal and economic policy action is needed to achieve a lasting solution to the current crisis and to prevent future crises? In my view, three conditions have to be met.

1. The first of these conditions is the rigorous implementation of budgetary consolidation and growth-enhancing structural reforms in the member states of European Monetary Union.
2. The second is a reform of the framework of the European Monetary Union that takes recent experience into account.
3. The third condition is further progress in financial regulation.

Financial regulation is a far-reaching and complex field, and I do not wish to go into that today. But please allow me to highlight just two points. The first is that, when European Monetary Union was established, financial markets were expected to act as an additional corrective measure against unsound fiscal policies. History has taught us, however, that because of low risk awareness, markets have not worked effectively as a timely sanctioning mechanism – and once they finally became aware of the risks, the response was quick and fierce. Nevertheless, the watchdog function of financial markets – of all of you here today – is indispensable. To be effective, financial regulation has to encourage investors to become aware of the risks and to signal them at an earlier stage. The second point I would like to mention is the painful lesson that contagion, via the financial system, has proven to be the Achilles heel of European Monetary Union. Hence, improving the resilience of the financial system, even though it is a major policy goal across the world, is particularly important in the context of our monetary union.

But let me now elaborate on the first and the second requirements of the euro area for overcoming the crisis – fiscal and structural reforms in the member states as well as a better framework for European Monetary Union. Significant progress has already been made with regard to budget consolidation and, to a lesser extent, in terms of structural reforms. This is true of the programme countries which have to comply with the conditions of the respective adjustment programmes. And it is also true of Italy and Spain, the third and fourth-largest euro-area economies, which have seen a significant rise in their bond yields. Their governments have embarked on labour market reforms and spending cuts. But there is no room for complacency. Flagging eagerness or too little disclosure of looming risks will be penalised immediately. We have to bear in mind that market pressure – together with political pressure – has fostered reforms and hopefully keeps them on track.

By the same token, however, investors should have some patience for reform measures to unfold. True, we are now in the third year of the sovereign debt crisis, and too often precious time has been wasted. But we should not forget that the adverse developments that led to the sovereign debt crisis emerged over a decade. Clearly, they cannot be reversed in a matter of weeks. The road to recovery is long and uneven; backlashes are to be expected.

Looking at Spain, the country on which markets are focusing presently, I wish to acknowledge that the government has already taken bold steps to address structural weaknesses, for example by overhauling some of the rigid labour rules. Yet it has become clear that the Spanish banking system needs more capital. Therefore, I appreciate the intention of the Spanish government to seek financial assistance from euro area member states. The financial assistance will be provided by the EFSF/ESM for the recapitalisation of Spanish financial institutions. Funds would not be provided directly to the banks but, in line with current EFSF/ESM rules, be channelled through the Spanish state, in this case the restructuring fund FROB. I am optimistic that this package will effectively mitigate the negative feedback loops between the banks' deleveraging and the real economy. But quick and decisive action is now warranted in Spain, and any further delay should be avoided, as the longer one waits, the more expensive it is likely to get. Conditionality only applies to the banking sector, but this makes it all the more important that the Spanish government itself pushes vigorously ahead with the reforms to tackle the structural problems of the Spanish economy.

It is definitely not the task of the eurosystem to substitute for national fiscal policies. This is true with regard to Spain, and it is particularly true with regard to Greece. Greece must do

everything in its power to strengthen its competitiveness. The country needs to stick to the agreed austerity and structural reform measures – no ifs, no buts. There is no basis for external aid without the agreed reform program. There can be no exception for Greece in this regard, as this would inevitably undermine the balance of give-and-take in other program countries, too. The repeat elections will show whether the Greek voters still support this way forward. If not, Greece must be aware that it puts further aid at risk. The consequences would be severe, and most severe for Greece itself.

As the Bundesbank has stressed time and again, the way Europe deals with the crisis in Greece will have far-reaching implications for the nature of European Monetary Union as a stability union. This is a deeply political question, and we have come to a point where policymakers can no longer avoid taking sides. Attempting to dodge this decision and muddling through as before no longer is an option. Rather, a further muddling through would also be an – implicit – response, and one of the least desirable ones, both from the perspective of a stability-oriented monetary policy and with regard to overcoming the crisis.

A crucial question with regard to public finances in European Monetary Union is whether the right cure is to prescribe frontloaded consolidation for all euro-area countries. A considerable number of experts are vehemently opposed to this approach. Paul Krugman, for example, sees the euro area spiralling into disaster. And George Soros is accusing many − including the Bundesbank, with its emphasis on frontloaded consolidation − of destroying the euro.

It will hardly come as a surprise to you that I do not share such views. Rather, I suggest that dragging out fiscal adjustment would have major negative effects. Of course, it is correct to say that, in normal times, consolidation dampens economic growth. Current circumstances, however, are anything but normal, and it is an illusion to believe that backloading consolidation would help to restore confidence. The current crisis is essentially one of confidence. On the other hand, one should not exaggerate the risks of a more restrictive fiscal policy stance, all the more so as the rescue packages and the extremely accommodative monetary policy stance do help to cushion the adjustment. The long-term benefits of frontloaded consolidation, I am convinced, will significantly exceed the short-run negative effects.

Nevertheless, there is an ongoing discussion on whether the euro area should shift its focus from austerity towards growth. Indeed, the crisis cannot be overcome without growth. This is very much undeniable. What is now being hotly disputed is the question of what constitutes the right approach to stimulating growth.

After ECB President Mario Draghi proposed a growth compact, he was getting applause from all quarters as long as he did not spell out what such a growth compact should comprise. He was not promoting a relaxation of the austerity course – either in programme countries or in countries facing close market scrutiny, nor in countries that are considered to have more fiscal leeway. On the contrary: He denied the existence of a contradiction between the goals of consolidation and growth. Instead, he pointed to the need for structural reforms in all member states of the euro area, in particular concerning product markets and labour markets. In this sense, I appreciate the Portuguese Prime Minister's support for Mario Draghi. He was quoted as saying: "There are no overnight structural reforms and the effects do not show up immediately, but we know that our capacity to grow depends on these reforms. They are the ones we are implementing." This could not have been expressed any better and clearer.

And I am confident that, once the implementation of structural reforms has started, investors will return even before the effects of these reforms have fully unfolded. Those who are currently short in European sovereign debt and the euro will have to decide when the right time has come to go long again.

The second requirement for a lasting solution to the current crisis and the prevention of future crises is the much needed strengthening of European Monetary Union's institutional framework.

For me, right now, it has become evident that European Monetary Union's constitutional setting is far from being sustainable. To make European Monetary Union sustainable two paths can be followed that I will briefly discuss subsequently: truly improving the Maastricht Treaty or building the foundations of a fiscal union.

With respect to the shortcomings that I have mentioned, we have already seen a number of accomplishments. The fiscal rules of the Stability and Growth Pact have been reinforced. The introduction of a reversed majority rule, for example, makes it more difficult for countries with excessive deficits to avoid sanctions. Second, member states have agreed to launch a Macroeconomic Imbalances Procedure in the euro area. The purpose of macroeconomic surveillance is to identify potential risks early on, to prevent the emergence of harmful imbalances, and to correct excessive imbalances that already exist. Third, the Heads of State and Government of the euro-area countries have agreed to "move towards a stronger economic union" and have announced a fiscal compact. The key component of the fiscal compact is a further strengthening of the commitment to bring the budgets of the member states at least close to balance in structural terms. To this end, fiscal rules will be tightened further at the EU level, and new rules will be introduced nationally. The UK has, unfortunately, not agreed to the fiscal compact. However, I appreciate that the Irish voters have given their clear "yes".

While the fiscal compact is certainly a major step in the right direction, it is far from being the cornerstone of a "fiscal union" in the euro area. The fiscal compact aims at strengthening the current framework, but its success will hinge crucially on the member states' willingness to implement and apply the rules. European authorities are not equipped with a supranational right to intervene in national budgets when member states do not apply the rules properly. Therefore, the fiscal compact – which has not been ratified by all member states yet – does not justify calls for monetary policymakers to further extend central banks' balance sheets. Nor does it substantiate any extensive joint liability.

Against this background the recent proposals of a so called banking union appear to be premature. Such a banking union, potentially comprising a euro area deposit-guarantee system, a euro area resolution fund and common euro area supervision for the largest and systemically important banking groups could very well represent a sensible step forward. Yet it has to follow a deeper fiscal union as it would imply significantly increased risk sharing amongst countries. Introducing a banking union without having established a genuine, democratically legitimated fiscal union would risk undermining the no bail-out clause and the disciplining effects of financial markets on fiscal policy. From a formal perspective it necessitates amending the EU Treaty – meaning it is very unlikely to be a short-term fix to the current challenges mainly related to recapitalisation needs in some banking systems, to political risks and to contagion effects within the euro area.

The same is true regarding the proposed introduction of eurobonds. This is where I respectfully disagree with Olivier Blanchard, the IMF chief economist, who was quoted as saying: "… the Germans had good reason to reject bearing the brunt of irresponsible policies by other states. But now we have a fiscal treaty." And he concluded: "The Germans should accept that the eurozone is going by way of eurobonds." Under the current framework, the issuance of commonly guaranteed sovereign bonds would actually increase the existing mismatch between liability and control. I think, that, at least for the time being, euro-area governments have been reluctant to surrender their fiscal autonomy to a European authority.

4. Conclusion

The euro area consists of independent member states. Each member state has its own constitutional tradition which has to be respected by its government. To some extent, the status of the euro area is similar to the Articles of Confederation drawn up in the late 1770s, which legally established the United States of America and served as its first constitution.

We do not necessarily have to become a United States of Europe. It is quite possible that a reformed Maastricht framework of truly self-responsible member states – in other words, the European Monetary Union as it was planned to be – will guide us to a sustainable monetary union. Or the peoples of Europe might indeed make the leap to a substantial deepening of European integration, particularly in terms of economic and fiscal policies. Both options are viable.

The decisions taken up to now do not yet indicate which direction Europe will take. However, there is absolutely no doubt as to the political will to ensure the continuity of European Monetary Union. Especially to observers from outside the euro area, and given the often slow decision-making processes, the strength of this commitment is underestimated.

We in the euro area believe in the continuity of the euro. And if the euro area embarks on the necessary reforms that I have outlined today, it will emerge from the crisis stronger than ever.

Thank you very much for your attention.