Lars Rohde: The European crisis and the development of the European Union

Speech by Mr Lars Rohde, Governor of the National Bank of Denmark, at the European Affairs Committee's consultation: "The European crisis and the development of the European Union", former Upper Chamber of the Danish Parliament, Copenhagen, 26 February 2013.

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Thank you for inviting me to speak here today.

The EU member states have been severely affected by the financial crisis and then the sovereign debt crisis. The recession is now in its fifth year. Many measures have been taken to contain the crisis, and more are in the pipeline.

Being a small, open economy, Denmark is highly vulnerable to developments in the EU. We participate in many community efforts, but not in the monetary union. We have opted out, but at the same time the krone is tied closely to the euro. The purpose of keeping the krone stable against the euro is to avoid exchange-rate uncertainty – which is very important to an economy such as the Danish one, with exports accounting for almost half of the gross domestic product. At the same time, inflation and inflation expectations are anchored to an area pursuing stability-oriented economic policies with low and stable inflation. The fixed-exchange-rate policy means that fiscal policy is the instrument at our disposal to stabilise the economy. This arrangement has served us well for 30 years.

Denmark's economic policy enjoys considerable credibility – also in the financial markets. This is why we have for some time been – and indeed, we are still – seen as a safe haven for international investors. This has resulted in historically low interest rates. Despite the most recent increase, Danmarks Nationalbank's deposit rate is still negative. The low level of interest rates has mitigated the real economic consequences of the financial crisis. But at some point interest rates will normalise.

The stability of the anchor currency – i.e. of the euro area – is important to the Danish economy. The political system in a non-euro area EU member state such as Denmark must perform a balancing act – how far should we go in terms of participation? This question was topical in relation to the issue of closer fiscal cooperation, as it is in the current process towards a banking union.

In the early 1990s, the European foreign-exchange market came under strong speculative pressure and one currency after the other came under attack. The crisis culminated in 1993 with speculation against the Exchange-Rate Mechanism, ERM, existing at the time. Some 20 years down the line, the financial crisis and sovereign debt crisis in certain European countries have once again put the European economic cooperation under pressure. The most recent crisis has differed from the situation in the early 1990s when each EU member state had its own currency. If national currencies had not been replaced by the euro in 1999, we could very well have seen an extensive currency crisis on top of the financial crisis and the sovereign debt crisis. For the euro area, the euro has prevented this. The Danish krone, on the other hand, was hit by short-term currency unrest in the autumn of 2008, as were other small currencies. Subsequently, the sovereign debt crisis has, from time to time, led to pressure on the krone, but this has been upward pressure due to large capital inflows.

A fixed-exchange-rate system is not in itself an effective bulwark against irresponsible policies. The euro area sovereign debt crisis could very well have taken a far more dramatic path, leading to disorderly sovereign defaults, without the variety of pan-European initiatives to solve the sovereign debt crisis that were the result of the economic-political cooperation between the euro area member states.

The introduction of the euro back at the turn of the millennium caused interest rates to drop markedly in many euro area member states, and yield spreads within the euro area were all but eliminated. But the interest-rate gains were not used for consolidation. Instead, they boosted domestic demand. As a result, competitiveness was eroded, and these member states saw increasing current- account imbalances. At the same time, housing bubbles emerged in several member states, and this later caused distress for the banks that had helped to fund property projects at inflated prices. The euro area systems for monitoring and addressing government deficits and other macroeconomic imbalances proved to be completely inadequate. This was one of the reasons why the imbalances were allowed to develop – and to become much more serious than they had been ahead of the crisis in the early 1990s. Furthermore, risk premiums on the government bonds of these member states were unsustainably low for a long period after the introduction of the euro. Hence market pressures for political action were correspondingly low. This changed abruptly when the financial crisis and sovereign debt crisis set in.

Since many countries had failed to take advantage of the favourable economic climate in the early years of this century to consolidate public finances, their position was weak when the crisis struck. Still, most countries eased fiscal policy in 2009 as part of concerted European efforts to offset the negative impact of the crisis on growth and employment. This caused further deterioration of public finances, and for several euro area member states it led to an outright sovereign debt crisis. One reason was that the banks' non- performing loans eventually became a problem for the public sector, thereby weighing down on government finances. In many countries, fiscal expansion during the boom immediately before the crisis has now made way for extensive consolidation. In other words, fiscal policy has amplified cyclical fluctuations instead of dampening them.

Therefore, the lesson to us all – from the ERM crisis in the early 1990s and recent years' financial crisis and sovereign debt crisis – is that it is important to address macroeconomic imbalances in time to prevent systemic risk. The financial crisis and the sovereign debt crisis revealed a clear need to strengthen political cooperation between euro area member states.

The most recent crisis has exposed at least two fundamental weaknesses in the EU's economic cooperation. Firstly, the pressure for budgetary discipline was not strong enough. Secondly, the one-sided focus on fiscal policy was too narrow. A comprehensive view of the member states' economic situation is required. It is also evident that price stability alone is not sufficient to ensure financial stability.

In recent years, the EU member states have adopted a series of new rules aimed at addressing these weaknesses, including the Fiscal Compact, which tightens the requirements for fiscal discipline. In addition, the EU member states have adopted rules for surveillance of macroeconomic imbalances, under which the European Commission is to monitor whether a member state is building up excessive imbalances. There is now more focus on systemic risk, and a European Systemic Risk Board, ESRB, has been set up. In Denmark, we have introduced the Systemic Risk Council, whose members were appointed last Thursday.

Although Denmark has, in many ways, navigated the financial crisis better than many other countries, we have generally had to learn the same economic policy lessons as others. In Denmark, too, fiscal policy in the pre-crisis years reinforced the boom rather than dampening it. Among other things, this led to higher wage inflation and weaker competitiveness. As a result of the procyclical fiscal policy, the downturn was more severe than it would otherwise have been.

But the underlying fiscal policy was sounder than in the member states now experiencing problems. This is true both in terms of cyclical stabilisation and long-term fiscal sustainability, although we lost focus in the pre-crisis years. The conclusion to be drawn from developments in the 2000s, not only in Denmark but throughout the EU, is that if fiscal policy is procyclical in a boom, it will have to be procyclical also in the subsequent downturn. Obviously, this is not expedient.

Denmark has chosen to adopt the Fiscal Compact as a framework for future fiscal policy. This has been reflected in a Budget Act with a more stringent sanctions regime vis-à-vis local and regional government – the levels at which it has, historically, been most difficult to observe budgets and agreements.

Major steps have already been taken to strengthen economic cooperation in the EU with stronger budgetary discipline and increased macroeconomic surveillance, but all the same it is essential that there is still political will to ensure that the policies pursued have a strong medium-term orientation while also dampening, not amplifying cyclical fluctuations. It is important to observe the spirit as well as the letter of the common rules. This also applies in the event of a future banking union.

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The financial crisis was succeeded by a sovereign debt crisis in the EU. This has revealed close negative interaction between the economy and bank finances in a number of member states.

To prevent the credit lending from collapsing, governments have had to use public funds to support the banking sector. At the same time, the sovereign debt crisis has made these governments more dependent on the banks, which buy up a large share of the domestic government bonds.

Fiscal developments have raised concerns about these member states' ability to continue to support the banking sector. This has had a negative impact on the banks' access to funding and reinforced the tendency for banks to reduce their lending. Since lower lending volumes may further curb economic activity, the economic challenges become even greater.

In the short term, the banking union represents an attempt to break the negative interaction between governments and banks. The vision behind the banking union is to prevent crises like the one seen in recent years and to mitigate the impact if a crisis should, nevertheless, arise. The aim is to shield developments in the financial sector from developments in public finances in individual member states – and vice versa – and increase financial stability. In the longer term, a banking union is to help support financial integration in the EU, and hence the single financial market.

Vulnerable euro area member states are facing major challenges in relation to both public finances and the financial sector. A banking union does not necessarily address these challenges. The reforms required in these member states will undoubtedly be costly and have real economic implications. It is imperative to find a solution to existing challenges in vulnerable states and banks so as to bring them back on the right track without undue delay.

Danmarks Nationalbank supports the overall vision for a banking union. A banking union makes good sense in an integrated financial market, where financial institutions are free to operate across national borders.

The single market for financial services has contributed to strengthening competition and the supply of credit, to the benefit of both the Danish financial sector and its customers. Integration within the European financial sector increased until 2007, but has since the onset of the financial crisis been decreasing. Like the other EU member states, Denmark has an interest in a well-functioning single financial market. I see merit in the current discussions on the establishment of a banking union as a mechanism for supporting financial integration in the EU.

Developing the individual elements of a banking union will be a huge task. If the vision is to be realised, the banking union must comprise at least three elements: (1) a single supervisory mechanism, (2) a single resolution mechanism for failing banks, and (3) a single deposit guarantee scheme.

Initially, focus has been on establishing a single supervisory mechanism under the auspices of the European Central Bank in order to solve some of the problems currently faced by some European banks. The single supervisory mechanism is primarily aimed at euro area banks, but non-euro area member states may opt in. The framework conditions will differ, depending on whether the member state in question has adopted the euro. At present it looks as if non- euro area member states will be able to participate in the single supervisory mechanism on an equal footing with euro area member states. This is positive.

The set-up with a single supervisory mechanism can enhance the credibility of financial supervision in the EU, especially in the euro area, and will contribute to financial stability, which will also be an advantage for the Danish economy – whether or not we decide to join.

The Commission is expected to table proposals for the remaining elements of the banking union later this year. The content is as yet unknown, and it is difficult to predict the final set-up.

The distribution of costs is a politically sensitive issue, not least in terms of whether legacy assets are to be included in the equation.

The establishment of a strong single deposit guarantee scheme, and not least a credible single resolution mechanism with bail-in for failing banks, is essential if the EU is to succeed in containing the negative contagion from banks to governments in a future banking union. In Denmark we already have a credible resolution mechanism, and we have retained our AAA rating throughout the crisis. Both have served us well. All the same, it cannot be ruled out that Denmark's independent resolution approach has increased the banks' funding costs in the short term, so it is important to establish a single European framework for resolution of banks.

The Danish banking sector is characterised by substantial cross-border activities among the largest banks. The consolidated assets of Danish banks amount to almost four times Denmark's GDP. In addition, the ratio of the largest Danish bank's consolidated assets to GDP is among the highest in the EU. Due to the size of the banking sector and the high degree of concentration, a single European insurance scheme, as provided for by a banking union, will, other things being equal, be attractive from a Danish point of view. After all, insurance schemes work best when many equal policyholders share the burden.

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Overall, I believe that it would be an advantage for Denmark to participate in the banking union once the remaining two legs – the deposit guarantee scheme and the resolution mechanism – are in place. Therefore it is important to remain firmly seated at the negotiation table and contribute to ensuring a robust and effective set-up which Denmark may join if we choose to do so.

If a credible framework is established for a banking union, and tax payers will not have to foot the bill when banks fail in the future, this will have a stabilising effect, not only within the euro area but also in other member states. As I see it, that is in itself a strong argument in favour of Danish participation in a banking union.

Thank you for your attention.