Andreas Dombret: The debt crisis and its consequences for the real economy

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Handelsblatt CFO Congress, Königstein, 20 June 2013.

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1. The close interrelationship of the financial sector and the real economy

Mr Brandt

Ladies and gentlemen

Thank you very much for your invitation. I am delighted to be speaking to you today. After all, my present position at the Bundesbank and my "earlier life" in the private sector mean that I am not only acquainted with the "real economy" but also that it is very important to me.

The European debt crisis is now in its fourth year, and it still holds great challenges: for governments and for parliaments, and, not least, for the banking sector, which has been at the centre of an ongoing deleveraging process since the outbreak of the financial crisis. And thus, without any question, the crisis represents a challenge for enterprises in the real sector – even for those which have been spared its immediate consequences in the shape of shortfalls in demand.

From the outset, I wish to admit that I do not have much use for the term "real economy" – even though I understand where it comes from and also use the term myself. Making a strict distinction between the real economy and the financial sector is, I feel, overstating things in some respects. We need both: enterprises and financial institutions. They are interdependent and should work together in confidence. Unfortunately, there are negative examples on all sides. It is my firm belief that we should not allow any "side" to condemn the other.

And the crisis has revealed what was probably obvious for a long time to the practitioners among us: the financial sector and the real sector are not two separate control loops. Rather, they are closely intertwined. It is on this relationship and the consequences of the debt crisis for the financing of the real economy that I would like to share my thoughts with you today.

As in any relationship, the relationship between the financial system and the real sector is characterised by both light and shade. On the positive side, the financial markets promote economic growth by directing scarce capital to its most productive use.

On the negative side, the real sector suffers through no fault of its own when the financial markets are facing a crisis. That much has been made abundantly clear by the financial crisis. But was the crisis really caused by financial markets that were "out of control" and then paid for by the real sector – and naturally also by the taxpayer?

This frequently voiced assumption is not entirely wrong, but it is not entirely correct, either. It is true to say that the financial markets can sometimes tend to overexuberance, which can play a part in the emergence of crises. It is also correct to say that some players in the financial markets had been neglecting risk management. And, finally, it is correct to say that the financial markets had moved away from their original role as an intermediary and thus as a service provider for the real sector. False incentive structures in compensation performed their part in all these undesirable developments.

Explaining the crisis only in terms of "out of control" financial markets falls short of the mark, however. Fundamentally, bank balance sheet mirrors what is happening in the economy. Playing down excesses is certainly not the intention here. But, in the debate on the sovereign debt crisis, it should be remembered that debt is not a bad thing per se. Enterprises are

normally reliant on borrowed capital to fund investments and thus make growth possible. Debt becomes harmful only if it grows on an excessive scale and capital flows into unprofitable areas. In the event of an asset price bubble, however, it is not only banks that have positioned themselves wrongly, but also investors and borrowers.

2. The ongoing deleveraging process

After an asset price bubble has burst, a deleveraging process is necessary, such as we are witnessing at present in many parts of Europe. You see, if an economy is facing a debt crisis as a result of a credit-financed bubble bursting, the value of the assets held by the private sector fall, while the value of the liabilities remains the same. Households and enterprises are compelled to increase their saving in order to pay off their debts. However, saving more to reduce debt leads to a decline in investment, which has a negative impact on economic growth.

As I have already mentioned, bank balance sheets mirror the real sector. As a result of the developments I have just described, banks, too, may also run into difficulties, however. Despite greater efforts to save, some borrowers do not manage to service their debts properly, causing some loans to default. That drains the banks' capital. At the same time, there is a decline in the institutions' creditworthiness on the interbank market, leading to possible shortfalls in their liquidity.

It is precisely these aspects of deleveraging which are potentially fraught with problems. In an unfavourable scenario, a shortage of capital and liquidity causes banks to curb their lending even to enterprises who really have no need to reduce their debt on account of their financial situation. These enterprises then become the collateral damage of a disorderly deleveraging process, with matching consequences for the real economy and, thus, for growth and employment.

What is crucial, therefore, is that such a process be conducted in an orderly manner. Enterprises which have a functioning business model and which produce competitive goods or services must be able to go on funding their activities, while enterprises that miscalculated before the crisis have to reduce their debt.

A good example of such an orderly deleveraging process is the strengthening of many German enterprises' capital base since 2000. Above all, formerly insufficiently capitalised small and medium-sized enterprises used their increased corporate profits during this period to raise their capital base and reduce liabilities. Overall, their capital ratio went up by 10 percentage points. In most cases, therefore, Germany enterprises already have their deleveraging process behind them. And that is very much to be welcomed.

For this process to succeed, three points were decisive. First, German enterprises' profits rose sharply during the past ten years, which made it significantly easier to build up capital. In other words, they made use of the cyclical tailwind in the last few years. Second, enterprises became aware at an early stage that the stricter capital requirements under Basel II would mean them having to meet higher standards of creditworthiness. In many cases, an increase in equity capital meant that it was possible to avoid higher interest charges or less favourable credit standards. Finally, tax law also gave a major boost to the greater accumulation of capital and reserves. The tax reform in 2000 removed the unfavourable tax treatment of reinvested earnings and created an incentive for retaining more profits.

Deleveraging yes, but not driven by a credit crunch: that is how a successful deleveraging process can best be summed up. Central banks can support this balancing act – but only to a limited extent. It is true that, by providing liquidity assistance to the banks, they can ease tensions on the interbank market – which, as we all know, is something they do. But they cannot adjust balance sheets by making equity capital available to the institutions. That is where others come in.

First of all, the onus is on the banks themselves to attract the required capital on the market. If that fails, recapitalisation by the state may become necessary. A recapitalisation of this kind should not be stigmatised, however. We need adequately capitalised banks which are strong and have a viable future so that they can fulfil their role as service providers for the real sector.

3. Market discipline in the financial system strengthens the real economy

Adequate capitalisation of banks is thus an essential precondition for conducting the deleveraging process in a way that is friendly to growth. But for Europe and, above all, the euro area to return to sustained growth, a great deal more still has to happen. The economic value added of a financial system is measured chiefly by how successful it is in directing capital into those areas of the real sector where it brings the greatest return. In this connection, the Single Resolution Mechanism for the restructuring and resolution of banks, which is currently under discussion as the second pillar of the banking union, also plays an important role. This is because, in a weakened banking system with excess capacities, the solution cannot lie solely in recapitalisation. It also has to be possible for individual weak banks to exit the market. Experience in Japan reveals very clearly what negative effects "zombie banks" can have on the real economy

With regard to the Single Resolution Mechanism, it is mainly its potential advantages for financial stability that are being discussed at present. In order to strengthen market discipline and minimise the risk of bank bailouts at the taxpayers' expense, shareholders and investors are to bear the losses in future. Abolishing implicit guarantees is indeed all-important. It is the only way to ensure that the banks' wholesale funding costs are an appropriate reflection of the risks they have incurred, which counteracts an excessive appetite for risk.

That benefits not just financial stability, however, but also the real sector and growth. This is confirmed by a recently published Bundesbank study.[1] A functioning resolution mechanism has a positive influence on the banks' decision-making process in lending. Banks having grounds to fear that, under the terms of an existing resolution mechanism, they will exit the market in a worst-case scenario lowers risk appetite to an appropriate level and increases the incentive to monitor loans carefully. This means that capital will tend more to be allocated to its most productive use. An effective resolution mechanism thus strengthens not only financial stability, but also economic growth.

A banking union will contribute to growth and financial stability only if it is designed in such a way that it continues to give incentives to act soundly to all parties involved. That applies not only to future risks, but also to ones that have already materialised. After all, a banking union implies a kind of insurance mechanism. And, as in every kind of insurance, only loss and damage that are not known in advance can be covered. For that reason, "legacy burdens" – in other words, those risks which arose under the responsibility of the national supervisory authorities – have to borne by the respective member states if need be. Anything else would amount to a government transfer payment.

Now, it may be that such transfer payments are considered desirable or even necessary. In that case, they should be made out of national budgets and with the approval of national parliaments and not under the guise of a banking union. I would therefore welcome it if the Ecofin negotiations on Friday of this week were to allow a direct recapitalisation of credit institutions by the European Stability Mechanism (ESM) only after all other available means have been exhausted. All things considered, it is extremely important to establish the functionality of the Single Supervisory Mechanism (SSM) as well as a single restructuring and resolution regime for banks.

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[1] Korte, Joseph (2013): Catharsis − The real effects of bank insolvency and resolution. Deutsche Bundesbank Discussion Paper No. 21/2013.

It is my firm belief that Europe has to make a success of this project and that it cannot afford to get off to a bumpy start. The banking union is anything but a quick-fix solution to the current crisis. However, it is a major milestone on the road to a more stable and more successful monetary union and thus crucial for restoring confidence within the euro area and overcoming the debt crisis.

4. What is now important

Ladies and gentlemen

The European debt crisis will keep us all busy for a while yet. In particular, what I wish for is that the relationship between the financial and real sectors again becomes and builds on what it used to be. Enterprises which have a viable business model and which produce competitive goods and services must also be able to finance their activities. A healthy banking system is essential for that.

The central banks of the euro area have already played a major part in this. Besides cutting policy rates to an all-time low, their non-standard monetary policy measures have enabled them to provide the banks with almost unlimited liquidity for a very long time. To do that, there was also a marked easing of the collateral requirements.

Equipping the banks with adequate capital, however, is a matter for the shareholders or, if need be, governments. Recapitalisations should not have a stigma attached to them. When they are necessary, they should be carried out quickly and convincingly. To do that, an independent, credible and transparent asset quality review is of vital importance.

Still more has to happen for Europe to return to sustainable growth, however. A functioning resolution mechanism benefits not just financial stability, but also growth. That is because it ensures that banks really do fulfil their allocation function and do not, as “zombie banks”, harm growth. This enhances the efficiency of the real sector. If we succeed in achieving such a milestone with a properly designed banking union, Europe will return to sustainable growth. Of that I am certain.