Andreas Dombret: The European sovereign debt crisis – past, present and future

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, to participants of the GMAP of Fletcher School, Berlin, 26 August 2013.

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1. Introduction

Dear Dean Nutter,

Dear Ambassador Scharioth,

Dear students of the Fletcher School,

Ladies and gentlemen,

On 25 March 2010, Jean-Claude Juncker, the President of the Eurogroup, made a statement on Greece. This statement included the following words: "As part of a package involving substantial International Monetary Fund financing and a majority of European financing, euro-area member states are ready to contribute to coordinated bilateral loans."

That sounds somewhat long-winded. Put simply, it means that the euro-area heads of state and government were ready to support Greece financially. That statement could be seen as the official start of the sovereign debt crisis in the euro area, the "starting shot" so to speak.

It wasn't of course the real start. The crisis was not something that happened suddenly, but rather the end of a long road. And the road leading out of the crisis is just as long. It is just as long, but much more arduous, particularly for those countries which are directly affected by the crisis.

And everyone agrees on where the road should lead: a stable monetary union. What is controversial, however, is what road we have to take in order to arrive at that destination.

In order to recognise the direction in which we have to go, we should first look at where we have come from. Let us therefore look back at the road that led us into the crisis, at its causes.

2. Looking back: the causes of the sovereign debt crisis

There are a very large number of angles from which it is possible to look at such a complex phenomenon as the sovereign debt crisis. And depending on the angle, it is possible to tell somewhat a different story. The core elements of those stories are always the same, however. We can find them at both the national and the European levels.

Let us first take a look at the national level; in other words, the countries themselves. Following the introduction of the euro, a large amount of capital flowed into the countries which are now at the centre of the crisis such as Greece, Ireland, Portugal, Spain and Cyprus. First of all, that is economically plausible: capital flows from highly developed countries into countries that are catching up economically.

In our case, however, the inflowing capital did not finance a sound catching-up process. Instead, it financed house price bubbles in some countries – such as Ireland and Spain. Elsewhere, it funded excessive government consumption – for example, in Greece.

The inflowing capital did not fund sound growth: instead, it masked an existing lack of competitiveness and, in fact, made it even worse. And it was precisely these structural problems that were the breeding ground for the crisis.

What was the situation at the European level? Here, it was mainly shortcomings in the framework of monetary union that laid the ground for the crisis.

In order to understand these shortcomings, it is important to know the particular features of monetary union. The European monetary union is special because it combines a single monetary policy with national fiscal policies.

The monetary policy for the 17 countries of the euro area is decided by the Governing Council of the ECB in Frankfurt. However, the fiscal policies of the 17 members of the euro area is a matter for the national policymakers – each country decides itself on its own government revenues and expenditures.

Given such an imbalance of responsibilities, the individual countries have incentives to borrow. You see, the costs of borrowing are spread across all the member states of the monetary union – for example, by means of a higher interest rate level for all of them.

This incentive to borrow, this "deficit bias", was also recognised by the founders of the monetary union. In order to reduce it, they did two things.

First, they created explicit rules on borrowing in the form of the Stability and Growth Pact. This Pact was intended to keep a tight check on national fiscal policies.

Second, the founders of monetary union incorporated the "no bail-out" principle into the Maastricht Treaty: no euro-area country was to be liable for the debts of another member state.

Thus, individual responsibility was to be the guiding principle for fiscal policy in the monetary union. Each country was itself to bear the consequences of its own fiscal policy.

These rules were intended to keep borrowing by the euro-area countries within reasonable limits. But rules were not the only means of achieving this. The financial market actors, too, were to ensure that that the euro-area countries did not incur excessive debt.

The idea behind this is simple: if a country were to become excessively indebted, it would only be able to borrow on the financial markets in future at very high rates of interest. This means that the country in question would have to reduce its debt to a sustainable level.

Yet, neither of these two safeguards worked. Neither the discipline of the financial markets nor the rules were able to prevent individual countries running up excessive debt.

Investors on the financial markets tolerated the problems of individual countries for far too long. At the same time, policymakers stretched and sometimes ignored the rules of the Stability and Growth Pact.

And then, in 2008, came the global financial crisis. Many countries had to rescue their banking systems and support economic activity. And that dramatically drove up their levels of sovereign debt.

And, suddenly, the investors on the financial markets seemed to become aware of the problems which some countries were experiencing. Now they saw the high level of sovereign debt, the lack of competitiveness and the risk of contagion effects between the individual countries. In short: they lost confidence in the crisis-hit countries. But this also meant that capital flows dried up – the capital flows that had previously covered up the problems.

And that brings us to the statement by the Eurogroup that I quoted when I began my speech. In order to safeguard financial stability in the monetary union as a whole, rescue packages were set up first for Greece, then for Ireland, Portugal, for the Spanish banking system and, finally, for Cyprus.

At the same time, central banks took various non-standard measures in order to stabilise the situation – I shall return to this point later.

In an exceptional crisis, taking exceptional measures is undoubtedly the right thing to do. However, looking to the future, neither course can provide a permanent solution to the crisis. Neither the rescue packages nor monetary policy can remedy the basic underlying problems that I have just mentioned.

3. Looking forward: ways out of the sovereign debt crisis

In order to achieve that, three things are necessary. First, government finances have to be put back in order; second, competitiveness has to be improved; third, the framework of monetary union has to be strengthened. Let us look at these three necessities in more detail.

3.1 Budget consolidation and structural reforms

Many euro-area countries have very high levels of sovereign debt. In Greece at the end of 2012, it was roughly one and a half times annual economic output. And in other member states, too, sovereign debt is well above annual economic output. Against that backdrop, reducing government debt appears to be an urgent necessity.

The associated course of fiscal consolidation has come in for some criticism, however. It is argued that, especially in a crisis, too many austerity measures place an unnecessary drag on the economy. However, a distinction has to be made at this point: in the long term, sound government finances are good for the economy – no-one disputes that. In the same way, no-one disputes that austerity measures can dampen economic activity in the short term.

But we should look beyond the present moment and, above all, not confuse cause and effect. What triggered the crisis was the very fact that governments were no longer able to borrow on the markets because they had already accumulated excessive levels of debt. Saving is essential in order to regain the confidence of the markets. That is the only way to eliminate the financing problems.

By the way, according to a survey by the Pew Research Center, in many countries a majority of the general public is in favour of fiscal consolidation – 81% in France, 67% in Spain, 59% in Italy, and 67% in Germany.

On one point, the critics are right, however: saving is not enough on its own, it is only part of the necessary structural reforms.

And that brings us to the second thing that is needed. Not only do the countries have to put their government finances in order, they have to reform their national economies so that they become competitive again.

There is no ready-made solution for this; each country needs different reforms. There is one common denominator, however. The labour markets have to be made more flexible. Flexible labour markets help enterprises to adapt quickly to changing conditions. This is not only important in crises; it also promotes the overall pace of economic growth.

All these reforms are painful and arduous. But they are indispensable and we are seeing initial signs of success. Ireland has already improved its competitiveness. Spain, too, has undertaken significant structural reforms and made good progress in reducing its current account deficit. It will now be important for the governments to maintain that course.

3.2 A better architecture for the monetary union

However, if we want a stable monetary union, it will not be enough to eliminate the problems at the national level alone. We also have to improve the architecture of the monetary union.

I cited the central weakness at the start of my speech: the imbalance between a monetary policy conducted at the European level and fiscal policies conducted at the national level.

Basically, there are two ways to realign this imbalance: either the European level gains certain control rights over national budgets – which would mean a deeper political

integration. Or we leave control of fiscal policy at the national level. But then the national level also has to assume liability for its policies – that would mean strengthening the Maastricht framework.

The first course would amount to what is known as a fiscal union. But that would depend on the countries of the euro area transferring national sovereignty to the European level – for example, by giving the European level the right to intervene in the case of unsound public finances.

Giving up sovereignty in this way would be a radical change and require wide-ranging legislative changes nationally and at the European level. More than anything, such changes would need the support not only of policymakers but also of the general public. And, on this point, we should be realistic. It is not possible to identify any willingness to do that at present – not in Germany or in any other country of the euro area.

This just leaves the second course of action: that is, an improved Maastricht framework, a "Maastricht 2.0". Among other things, that means strengthening the rules on borrowing – the Stability and Growth Pact not only needs teeth, it also has to be able to bite. The rules have since been tightened – now they have to be applied and complied with.

A "Maastricht 2.0" would also mean taking the no bail-out principle more seriously again. But that calls for the possibility of sovereign default as the ultimate logical conclusion of individual responsibility. Sovereign defaults have to be possible without destabilising the financial system of the euro area as a whole.

3.3 The banking union as part of a better architecture

And that is an important point, because the close link between government finances and the financial system was a major element of the crisis.

Basically, this is very much a vicious circle: if public finances run into difficulties, the banks are put under strain– if the banks hold government bonds on their balance sheets, for example.

Conversely, if banks run into difficulties, public finances are put under strain. Take the example of Ireland: in order to save its banking sector, Ireland ran up a budget deficit amounting to 30% of its economic output in 2010.

There are various approaches to breaking through this vicious circle. One of them is the planned European banking union.

The banking union consists of two elements. One element is joint banking supervision for large banks, the Single Supervisory Mechanism. Joint supervision would allow banks everywhere to be supervised according to the same high standards. It would also make it possible to take better account of cross-border effects.

But all of that cannot entirely rule out the possibility of bank failure. And that is a good thing. After all, the risk of corporate failure is a core element of the market economy.

Therefore, measures have to be taken to ensure that banks can fail without placing a strain on government finances. And this is where the second element of the banking union comes into play: a single resolution and restructuring mechanism for banks. And that, too, is under development at present.

Properly equipped, the banking union is thus a key component of a stable monetary union. With the banking union, government finances will be better protected in the future against crises in the banking sector.

But we have to break through the vicious circle from another direction, too. We also have to protect banks from government finances running into difficulties.

One of the most important measures in this respect concerns banking regulation. Banks should back government bonds with capital that corresponds to their risk.

For one thing, this would strengthen the market mechanism: banks would have an incentive to demand appropriate risk premiums for government bonds. That, in turn, would be an important market signal for governments. For another, it would also create a buffer protecting banks against a government running into financial difficulties and its bonds losing value.

4. The role of monetary policy

I believe one thing has become clear. The crisis cannot be easily resolved just like that – there is no magic formula for solving all the problems at one stroke. Instead, we need reforms at many different levels. We are undoubtedly making progress, but we have not yet reached our destination.

Travelling the rest of the way will certainly not be easy. Nevertheless, policymakers must not give in to the temptation of taking what they think is a convenient shortcut. And that brings me to the last point in my speech: monetary policy.

Monetary policy has already played a big part in helping to contain the crisis. But it cannot resolve the crisis – everyone is in agreement on that. And, with the measures taken so far, it has already ventured far into unknown and dangerous territory.

It is no secret that the Bundesbank takes a critical view of the ECB's government bond purchase programmes in particular. If Eurosystem central banks buy government bonds issued by countries with poor credit ratings, the risks of an unsound national fiscal policy will be spread across all the euro-area states.

But only elected parliaments should decide on such a redistribution of risks, not independent central banks. And that is more than a problem concerning the theory of democracy. It might indeed also be a temptation to call central bank independence into question. And that would be disastrous in terms of central banks' ability to safeguard price stability.

All that monetary policymakers have done so far has bought time for governments to solve the crisis. It is now up to governments to use that time, because monetary policy measures are not without risks and side effects. We should be aware of that.

5. Conclusion

I would therefore like to stress once more how important it is for the reforms in Europe to go ahead. Undertaking the necessary political steps is the only way to achieve our common goals of a stable monetary union and a stable euro.

And the economic advantages of a single currency will benefit all the member states – including Germany. Of course, it is extremely difficult to put an exact figure on the concrete benefit. However, the people seem to understand to what extent they benefit from the euro. According to a recent poll by the forsa Institute nearly 70% of the Germans favour the euro.

But we should not think about the euro only in economic categories. As long ago as 1950, the French economist Jacques Rueff noted that Europe will be made though the currency or not at all.

The euro is not only an economic project. It is also a political project. It is an important building block of a united Europe. Not least for that reason, it is something that is worth fighting for.

Thank you very much.