Andreas Dombret: Holistic approaches to solve the “euro crisis”

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Global Economic Symposium, Kiel, 1 October 2013.

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Ladies and gentlemen,

Thank you for the invitation to this year’s global economic symposium; it is a pleasure to be here. The “euro crisis” has certainly been, and it still is, a defining moment in the history of European Monetary Union – though I would add that we are dealing with a sovereign debt crisis rather than a crisis of the euro. Let me kick off the discussion by offering some thoughts on how to solve the crisis.

What we need is a holistic approach. Since the European Monetary Union is a highly interdependent system, any solution must not only remedy the problem at hand but also improve the working of the system as a whole. Unfortunately, many of the proposed solutions fall short of this requirement.

Instead, they are prone to what is known as the “cobra effect”. The cobra anecdote is set in colonial India. Trying to stop a plague of cobras, the British government offered a bounty for every dead snake. The plan seemed to be working at first. High numbers of dead cobras were presented to the colonial administration. Unfortunately, this did not get the plague under control. Most of the dead cobras were not wild ones – they had been bred by enterprising locals in order to claim the bounty. When the governor finally caught wind of the practice, he scrapped the reward, causing the cobra breeders to set the now worthless snakes free. As a result, the plague was worse than ever.

Every policy not only addresses a problem, but changes the nature of the game as well. This has to be taken into account when evaluating the overall merit of any measure. And when we look beyond instant effects, many policies lose their lustre.

Eurobonds are a case in point. Granted, eurobonds would offer temporary relief to heavily indebted member states of the euro area. But the introduction of eurobonds would distort the already lopsided balance between liability and control even further. While spending decisions would essentially remain a national prerogative, liability would become European. Incentives to incur further debt would thus be strengthened, not weakened. This would strain rather than smooth the working of the system.

Only if common liability were matched by common control would incentives be aligned sufficiently, as the IMF pointed out in a recent report.[1] But even though the fiscal pact has stiffened the rules, genuine European control of fiscal affairs still requires a quantum leap in terms of ceding sovereignty to the supranational level.

As this seems to be out of reach at the moment; steps are needed that encourage each part of the system to behave responsibly, while at the same time making the system more robust against failures of its constituent parts.

Severing the overly close link between banks and sovereigns is a crucial example in that regard. The banking union goes a long way towards ensuring that taxpayers do not foot the bill in the event of a bank failure. Defining a clear hierarchy of creditors is crucial in that regard. Shareholders and creditors have to be first in line when it comes to bearing banks’ losses. The proposed Bank Recovery and Resolution Directive is a big step forward, but the

[1] “Toward a Fiscal Union for the Euro Area”, IMF Staff Discussion Note, September 2013.

current proposal still allows for discretionary exemptions from bailing in creditors. In the interest of market discipline, this should change.

And to further strengthen market discipline, the Single Resolution Mechanism will have to ensure that banks without a viable business model can exit the market in an orderly fashion. Such a regime is crucial not only for financial stability, but for sustainable growth as well. A functioning resolution regime strengthens incentives for effective credit monitoring and moderates banks' risk appetites. In so doing, it enhances the allocation of capital and reduces the risk of a bubble emerging.

But the sovereign-bank-nexus goes both ways. We also need to make sure that worsening public finances do not infect the financial system. The banking union still has a sovereign virus, as Daniel Gros from the Centre for European Policy Studies puts it.

To strengthen the banking union's immune system, we need to end the preferential treatment for sovereign debt. Sovereign bonds have to be adequately risk-weighted, and exposure to individual sovereign debt should be capped, as is already the case for private debt.

At present, sovereign bonds are treated by European regulators as risk-free – an assumption that stands in contradiction both to the no-bail-out clause and to recent history. An adequate risk weighting of sovereign bonds would make banks more resilient if the fiscal position of the respective sovereign were to deteriorate. And it would bring spreads more into line with the underlying risk, thus giving a disciplining signal to the sovereign.

But sovereign bonds pose a threat to financial stability not only because of preferential risk-weighting. The most important rule in risk management is diversification. Yet when it comes to sovereign bonds, banks all too often neglect this principle. In many cases, European banks hold bonds from one sovereign only – their home country. Large and undiversified exposure is what makes a sovereign systemically relevant. Hence, the large exposure regime which caps the investment in one single debtor has to be applied to sovereigns as well.

Only then will the failure of a part not equal the failure of the system as a whole.

Thank you.