

Andreas Dombret: German unity and European integration – where are we heading?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the ceremony marking the Day of German Unity, Münster, 2 October 2016.

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1. Introduction

Mayor Lewe

ladies and gentlemen

It is a great joy and honour for me to be here in my hometown of Münster to deliver the address at this ceremony marking the Day of German Unity because, in a certain sense, it was here in Münster that the foundation of what we are celebrating today, namely German unity, was laid.

I am thinking, of course, of the Peace of Westphalia, which was signed in Münster in 1648. It put an end to the Thirty Years' War, in which soldiers from almost all of the European powers had fought against each other since 1618, claiming millions of lives. I don't intend to delve too deeply into the history of it, but here today I wish to highlight an important lesson from the Peace of Westphalia. It marked the first time that the countries of Europe occupied themselves with the continent as a whole – they desired to take responsibility for Europe together. The negotiations at Münster were, if you will, somewhat like a CSCE, a "Conference on Security and Co-operation in Europe".

At the same time, the Peace of Westphalia also paved the way for our federal system: the rights of German territorial princes were strengthened, thereby making the German regional states independent players that could help shape European politics.

In the Peace of Westphalia, all the European partners committed to guaranteeing security in Europe. We also experienced something similar in 1990 when Germany was reunified: without European integration, German unity certainly would not have come about.

2. Heading in the right direction: German unity

We are able to celebrate the 26th anniversary of German unity this year thanks not only to the courage of the people living under communist dictatorships but also to our partners in Europe and the United States. Because they, and Michail Gorbachev with them, trusted that German unity also serves the goal of European unity, they agreed to reunification – a gift that should serve as a reminder of our duty.

"Unity is a little like democracy: it is never finished." This phrase was uttered by former German President Horst Köhler, and it is no less true after 26 years of German unity. Despite facing many challenges, Germany has continued to grow since 1990 and it is today hailed as a reliable partner, perhaps even a role model, for many people in Europe and beyond.

Saying that, I certainly do not wish to ignore the fact that the past few years have been difficult for many people and that challenges still lie ahead of us today. Even though Germany did not bear the brunt of the euro crisis, it has nevertheless clearly left its mark here, too. Many people are looking to the future with an acute sense of concern and uncertainty. Quo vadis Europe, quo vadis euro? How will we manage to cope with the large influx of refugees to our country and find good ways of living together? These are all questions that people in Germany, in Münster, are

asking. And they deserve honest answers.

But one thing is very important to me: for all the challenges we face, the path we have taken over the past 26 years is a clear path, the right path. Germany is moving towards unity, towards integration. We are certainly not glossing over matters when we say that Germany has grown ever closer over the last 26 years. That's something we can be grateful for and we must press ahead on this path, with all the energy and commitment we can muster.

3. Sliding back into crisis?: European integration

Looking beyond Germany's borders to Europe gives me much greater cause for concern, for there I see a continent, our continent, facing a crucial test. For me, matters came to a head when the UK recently decided to no longer be a member of the European Union.

In my eyes, Brexit is more than just a manifestation of euroscepticism in the UK – it is primarily a sign of deep uncertainty surrounding the European project – and that's certainly not confined to the UK. "Europe does not grow out of treaties, it grows out of the hearts of its citizens, or not at all." This is how former German Foreign Minister, Klaus Kinkel, put it back in 1992. He was right then and he is right now.

The European Union may well have made important projects such as the euro, the Schengen zone or the common foreign and security policy a reality, but today there is deep mistrust of "the elites in Brussels", unfortunately. In all these years, Europe hasn't managed to reach people's hearts.

Besides the current challenges – besides Brexit, I'm thinking of topics such as the influx of refugees or the still unresolved sovereign debt crisis in the euro area – it has never been a better time, then, to start the conversation on the future direction of the European Union and to counter the Brexit shock with substantive and necessary reforms.

A wide variety of future scenarios for the EU will be debated, ranging from a return to the nation state to a political union. Between these two extremities, one idea is to establish an asymmetrical union – with a political union, a core consisting of Germany and France as trailblazers. This idea of a kind of multi-speed Europe, if you like, was most recently discussed by German Foreign Minister Franz-Walter Steinmeier, who called on the EU to become more flexible and "to make it possible for groups of member states to go ahead in certain areas, to experiment and to be open to others joining later." Another idea, recently suggested by Banque de France President François Villeroy de Galhau, was to create a "financing and investment union" in which all the surpluses in the EU would be pooled and transferred to investment projects. As you can see: the options and ideas are out there. I don't wish to delve any deeper into these debates or give my backing to any particular idea – such far-reaching decisions are a matter for politicians and for citizens, certainly not for a central bank.

But Brexit drove home the point that, whatever kind of future Europe the peoples of Europe opt for, simply carrying on as before will not move the European project forward, but most likely do it lasting damage.

4. Quo vadis Europe?

This is mainly down to dissatisfaction with the EU, which, as we know, is not a uniquely British phenomenon, but has become significantly more widespread in many member states. Domestic political motives go some way towards explaining this dissatisfaction, of course, but the

European Union's specific actions also play their part. Examples include how it has dealt with refugees or the sovereign debt crisis, or the general "value for money" offered by harmonised rules and "ever closer union" – I won't go into detail on individual topics at this juncture, as that, too, would overstretch my mandate as a central banker.

But there's one question that crops up time and again: how capable is the European Union of taking effective and efficient decisions? The EU has yet to demonstrate its ability to handle diversity – be it cultural or economic – and to channel it in the right directions.

This becomes very plain to see when we take a look at the euro area, say. What we have experienced in monetary union shows just how difficult it is to handle diversity. Needless to say, the individual constituent countries of an economic area that is as large as the EU develop differently and won't respond in the same way to changes on account of their economic and societal structures. So the underlying question is this: how can monetary union be made more crisis-resilient in spite of its diverse structure?

One challenge we have to come to terms with on a daily basis is the fact that there are 19 different economic and fiscal policies and just a single monetary policy in the euro area. This set-up makes it more attractive for member states to run up debt, because it lets them pass on some of the negative effects of higher debt levels to all the other participating countries. They can socialise their debts, so to speak. In concrete terms, this means that individual states bear liability for unwelcome developments in other countries without having a say in decisions. However, as Walter Eucken once put it: "Whoever reaps the benefits must also bear the liability."

The founding fathers of monetary union endeavoured to bear this regulatory principle in mind, not only by enshrining the no-bail-out clause in the EU Treaty but also by setting ceilings for government debt and new borrowing. They knew full well that unwelcome developments in the fiscal policy of one member state could jeopardise the stability of the entire structure.

And that is precisely what happened when the sovereign debt crisis hit. The safeguards in place were no longer able to stem the member states' ever-rising debt levels, with the end result that doubts about the financial soundness of individual member states led to doubts about the cohesion of the euro area as a whole. These doubts could only be appeased with the aid of government bailout programmes and Eurosystem measures. In the case of the latter, the first thing that comes to mind is the disputed purchase of government bonds from crisis-stricken countries.

The emergency measures rolled out over the past few years have undoubtedly helped to restore stability in our monetary union in the short term. Yet these measures increasingly introduced the element of joint liability without monitoring powers being transferred to the Community level to the same extent. But that, taken by itself, undermines the Maastricht framework and its core principle of national fiscal responsibility.

So what's the next step now? Essentially, I see two possible paths.

First, we can achieve a permanently stable governance framework if we push back the element of joint liability. For example, mechanisms could be put in place to ensure that member states themselves really are liable for unwelcome developments in their countries. This would give the no-bail-out clause renewed credibility and ensure that member states with less sound public finances also have to pay higher interest.

Second – and this would undeniably be a bold step forward – a fiscal union could be created. This would shift much of the responsibility for fiscal and economic policies to the supranational level, thus restoring the balance between action and liability.

A fiscal union such as this would be the biggest step in the integration process since the

introduction of the euro. However, the transfer of sovereign rights to the European level which this would entail would prove impossible without extensive changes to primary law and votes throughout the member states.

Politicians alone – not a central bank – can decide how action and liability can be brought back into alignment in the euro area. And if politicians opt for the path that leads to more centralised fiscal policy, appointing a European finance minister or establishing a joint ministry of finance would be two possible ways of effectively establishing control over European fiscal policy at the European level.

Politicians' unwillingness hitherto to embrace further steps towards a more centralised fiscal policy might have something to do with the major political obstacles I mentioned earlier on. For my part, I sense there is little political enthusiasm to push for "more Europe" in fiscal policy matters at the moment, because it is naturally extremely difficult for a country to renounce sovereignty over its own budgetary policy.

If things stay as they are, the only way forward is to tackle and rectify the flaws and contradictions of the Maastricht framework – a regime that remains in force as hitherto and is built around the idea of individual national responsibility. What this means, above all, is preventing unwelcome developments in the economic and fiscal policies of individual countries from posing a threat to financial stability in the currency area as a whole. After all, this was the reason why the European partners had to throw a financial lifeline to Cyprus, Greece, Ireland, Portugal and Spain during the sovereign debt crisis and are still having to do so to a certain extent today. It was also the reason why the Eurosystem launched purchase programmes for crisis countries' government bonds.

5. Disentangling the Gordian knot: the sovereign-bank nexus

A no-bail-out clause will only ever be credible if it is possible to restructure government bonds without jeopardising financial stability. But by the same token, this means putting an end, once and for all, to the tight sovereign-bank nexus that still persists in many euro-area countries. This nexus primarily comes about when a country's banks hold huge amounts of government bonds in their books.

The Bundesbank was quick to point out that the preferential regulatory treatment afforded to government bonds plays a major role in this regard. Under the current regime, banks are not required to set aside any capital against exposures to euro-area sovereigns, but they are for loans to enterprises or households. Nor are there any caps or ceilings on their lending to these borrowers.

Banks, therefore, have a huge incentive to invest in government bonds, at least in the short term. Sovereigns likewise stand to benefit in the short run since they can raise funding relatively easily thanks to the artificially inflated demand for government bonds – yet at the same time this lessens the pressure on them to consolidate government finances and to reduce their debt to sensible levels.

However, the crisis made it more than clear that even euro-area countries' government bonds can be exposed to risk. This is why, in my view, capital requirements need to be extended to cover banks' on-balance-sheet lending to sovereigns according to their risks.

Also, I still think it makes sense to cap banks' exposures to individual sovereigns – much like the large exposure limits that exist for private sector borrowers. That way, even if those sovereigns were to default, banks would still be sufficiently capitalised.

If the preferential regulatory treatment afforded to sovereign debt were done away with, this would also increase investors' incentives to take greater account of the differing risk profiles of the individual states, which in turn would strengthen the disciplinary function of capital markets. Countries that pursue unsustainable fiscal policies would then have to pay higher interest rates on their debts. So the area where political action is needed has been staked out – now it's up to the EU to demonstrate that it is, in fact, willing to act.

6. Conclusion

Ladies and gentleman, "Europe is like a bicycle. If it stops, it will fall over." This phrase was coined by former President of the European Commission Jacques Delors, and it aptly describes the dynamics that we have seen so far in the storyline of the European Union. Since it was founded, the EU has steadily continued to develop, constantly taken over new tasks and policy areas and created new institutions. But the UK's sudden decision to dismount has made the bicycle lose its balance.

So now it is high time that we stop the European bicycle for a moment and take stock of where our journey is taking us. We might even have to change direction. Aimlessly pedalling on cannot and will not be the solution.

What will be decisive over the medium to long term is that we find good solutions to counter the near-chronic sense of dissatisfaction with Europe's institutions. Any deficiencies we identify must be tackled in a decisive manner. Europe needs to demonstrate its ability to embrace credible political reform. We Germans, especially, need to be aware of our responsibility for making the European project a success, just as our partners in Europe contributed to the success of German unity, which we are celebrating here today. And I firmly believe that European unity deserves to be celebrated and defended as proudly as Germany's. The unification of Europe is a wonderful peace project – it was not for nothing that the EU was awarded the Nobel Peace Prize in 2012 – and there could not be a more appropriate location for this celebration than Münster, a City of Peace.

Thank you for your attention.
