Andreas Dombret: Current challenges in the euro area. A view from Germany

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at Columbia University, New York City, 20 April 2017.

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Ladies and gentlemen,

It is a great pleasure to be here at Columbia University today. It is an excellent occasion to cherish the transatlantic exchange of ideas – something that has accompanied me throughout my entire career and from which I personally have always benefited.

For the next half an hour, I am going to talk about the current challenges in the euro area. I hope that the subjects I have chosen will be of interest to you from a transatlantic perspective.

1. Current challenges in the euro area

From a central banker, engaged in banking supervision, you might expect a focus on issues concerning banks and financial regulation. I must disappoint you in that respect, as I only wish to briefly touch on the European banking sector: Undeniably, the health of the banking sector and the health of the overall economy are mutually dependent. In the euro area, banks play a much larger role in financing the economy than, for example, in the US.

And the banking sector is, indeed, facing several challenges. For example, in some euro area member states, banks have a high ratio of non-performing loans. This ultimately has the potential to become problematic from a macroeconomic perspective, as institutions that have a high ratio of non-performing loans tend to be preoccupied in dealing with these and have less time and energy to spend on financing the economy. Another structural challenge is the profitability of euro area banks. While banks are markedly better capitalized today than in the wake of the financial crisis, their rather low profitability might hamper their resilience in the future.

To be honest, these two challenges imply a lot of work ahead, not only for euro-area banks, but also for their supervisors. What I would like to assure you is that the ECB and its national partners are fully committed to keep up with these challenges. And also banks and their management are fully aware of the homework laid upon them.

Therefore, instead of talking to you about financial regulations, I would like to use this opportunity to comment on more fundamental issues.

Whether it be Brexit or the election in France in three days' time, Europe is experiencing serious headwinds with regard to its most ambitious project: European integration. Populism is at worrying levels, accompanied by a growing skepticism toward many forms of transnational cooperation, not least in the United States.

One of the drivers of rising skepticism has certainly been the euro area crisis – which has been a crisis of confidence – and its negative economic impact. Meanwhile, the euro area economy is in much better shape. Last year, euro area GDP grew at 1.7 percent – faster than potential GDP. This has also had a positive effect on employment. Unemployment in the euro area is still higher than before the crisis, but it's at its lowest level since 2009. The average unemployment rate currently stands at 9.5 percent.

But this evidently does not provide the full story when it comes to the state of the euro area. The challenges are complex. As H.L. Mencken, an American journalist with German roots, once said, “to every complex problem there is an answer that is simple, clear and wrong". In line with this, I

will take a closer look at two major issues of the euro area and the European project, namely

1. The quest for a suitable institutional framework, and

2. The question as to whether the cooperative framework underpinning the European project and international arrangements is outdated.

2. Towards a suitable institutional design

The institutional arrangements of the euro area remain its key challenge. The euro crisis, in particular, revealed severe structural flaws. Let me briefly summarize the main lessons learned to give you a better understanding of the current reform challenges.

The crisis demonstrated how much the euro area requires a framework that is able to absorb shocks and deal with heterogeneous issues across regions and member states. A key part of this challenge is that member states tend to be exposed to divergent regional developments while at the same time the single currency makes currency appreciation or depreciation no longer available as an economic policy tool. Principally, member states may address their regional issues by employing independent fiscal and economic policies. In a currency union, the burden of excessive debt can be partially shifted to other member states. This increases the incentive for member states to avoid politically difficult decisions in the short term by borrowing more.

It is important to remember that this problem had been foreseen from the very outset. The founding fathers of the European monetary union put rules in place to prevent negative spillovers. However, in practice, the rules have not always been followed, not least because of the short-term incentives that I have already mentioned.

The current challenge is not only about solving this institutional imbalance, but also about achieving this in a politically, economically and socially feasible way. In other words, Europe is struggling between easing short-term pain and committing to long-term reforms.

Let me give you a brief idea of the two options for long-term reforms. In both cases a stable, long-term solution for Europe can only be achieved if actions can once again be reconciled with responsibility for their consequences.

The first option would be a bold institutional step forward and would shift responsibility for fiscal and economic policy to the supranational, or European, level. In other words, the creation of a fiscal union.

A fiscal union would undoubtedly be the largest step in the European integration process since the launch of the euro. However, transferring sovereignty to the European level would prove impossible without extensive Treaty amendments and referendums all over the EU. Appointing a European finance minister or establishing a joint ministry of finance would be two possible ways of enshrining fiscal control at the European level. Admittedly, there is currently little prospect of finding political support for a fiscal union.

The second option would be to eliminate the flaws and inconsistencies of the current framework. That would imply a restoration of the core principle of national responsibility. What this means, above all, is that the repercussions of national decisions on economic and fiscal policy must no longer be capable of jeopardizing the financial stability of the euro area as a whole.

Experience has shown us the need to focus on a set of credible policy rules in the euro area – in other words rules that do not provide governments with incentives to flout them. And, equally important, rules need to fit together – creating a consistent incentive structure.

Let me demonstrate this reasoning with respect to the so called sovereign-bank nexus. This is

the unhealthy relationship between countries and their banks, whereby banks lend on a large scale and without a capital charge to their home countries, while governments simultaneously find they must support struggling banks in order to prevent an immediate crisis. The sovereign-bank nexus still persists in many euro-area countries and is an important impediment to a credible no bail-out clause. If banks are too strongly exposed to their own governments, this can hinder a market-based regime of public debt, namely the possibility of restructuring government bonds without jeopardizing financial stability. To tackle the sovereign-bank nexus, one important step is to reduce the existing incentives for banks to lend to their governments on an unhealthy scale.

As you see, there is no easy way to tackle the institutional imbalances in the euro area. If we want a feasible and durable solution, we have to get into the nitty-gritty of individual policy fields.

3. Cooperation between sovereign countries

Let me now turn to another fundamental challenge that we are currently facing in the euro area – as well as globally, I might add. I am referring to the questions raised about the value added by international and transnational cooperation. Cooperation used to be the fuel for the engine of European integration. Today, Brexit, nationalist movements in Europe and the resurgent protectionism are giving us pause for thought: Might we have put too much stock in cooperation? Are the benefits it brings insufficient to justify its costs?

The added value of international trade is at the core of this debate.

For a long time, the utility of international trade was undisputed, and international politics thus concentrated on ever-more detailed arrangements and standards. But all of a sudden, debates have been not about the degree of economic integration anymore, but about whether we should cooperate at all. Even mercantilism, dead for centuries, has found its way back into politics. I think this trend is leading us down the wrong path and will not help us find tangible solutions. The social and economic issues that countries across Europe and across the world are facing are not at odds with the conventional wisdom regarding international trade. But, as ever, it’s complicated...

What globalization statistics show is that economic integration does indeed raise aggregate wealth. Worldwide exports and imports have reached roughly 60 percent of global GDP[1] and global economic integration has surged in recent decades. At the same time, real income has grown globally and across the income spectrum since the 1980s.[2]

These developments are not accidental side effects. Indeed, trade theory predicts a more efficient allocation. This happens for a variety of reasons, such as comparative advantage or economies of scale. Economic integration also facilitates knowledge transfer, bringing innovation to places that would otherwise not have benefited from these technologies.

At the same time, just because trade leads to gains overall does not mean there won’t be some left worse off. This has been studied since the early days of international economics. Recent surveys have identified groups that have suffered from international trading arrangements, at least relative to their national peers.[3] These effects are not proof that international trade theories have failed – indeed they are part of the evidence that the theories are right.

Accepting trade theories thus demands accepting that negative side effects may – and most probably will – occur. There is a broad consensus among internationally active politicians that those side effects need to be met with appropriate counteractive policies.

But beyond the theoretical disputes, what can actually be done about these side effects of economic integration? Jurisdictions may, in principle, wish to employ tailored social policies to target unwanted inequalities and cases of social hardship. However, there are political

economists that have challenged the compensatory “menu” of national politics. One important contribution in that field stems from Dani Rodrik. He has even labeled international integration as a “golden straightjacket” that allows for increased overall wealth at the cost of fewer options for local politics. Allow me, if you will, to read out one of his quotes: “Governments today actively compete with each other by pursuing policies that they believe will earn them market confidence and attract trade and capital inflows: tight money, small government, low taxes, flexible labor legislation, deregulation, privatization, and openness all around.” I think his observations on the matter can hardly be ignored.

So how constricting is the golden straightjacket of globalization? Do we perhaps even need to take a step back from current international integration in order to allow for a broader range of national policies? I, personally, take a more optimistic approach for several reasons.

First of all, we should not expect protectionist policies to lead to fewer constraints for local politics. Instead, these policies reduce the size of the overall pie available for distribution. Countries withdrawing from international cooperation will very likely see the size of their respective pies shrink. Even more importantly, impediments to trade do not address major root causes of social imbalances such as technological innovation and the vital role of job qualifications. Admittedly, we cannot fully disentangle the role of technological improvements from the role of international trade in explaining economic growth – or widening income inequality. However, innovation does have a major impact on the social structure of a country. Endorsing protectionist policies will not enable politicians to evade issues of social cohesion within their countries.

Secondly, extensive participation in international trade does not preclude social benefits. In fact, the member states of the euro area provide social benefits that are quite “competitive” – so to speak.

Thirdly, we should value the positive effects of international standards. They may help to maintain a level playing field and to prevent a regulatory race to the bottom in policy fields that serve the whole of society.

Therefore, I do not entirely follow Rodrik’s reasoning. Still, what I see as his most important message is that we should not artificially separate international economics from national or regional politics.

4. Outlook

Ladies and gentlemen

With regard to the complex challenges facing the euro area, I have certainly not presented you with a solution that Mr Mencken would have regarded as simple, clear and wrong. Instead, I have tried to show why solutions to these challenges have not yet been found.

Let me highlight two key messages.

1. Regarding the two challenges that I have discussed, their complexity results from interactions between the economic and the political sphere. Solutions cannot be found merely by treating the symptoms; instead, we need to tackle the underlying causes. For academics and policy makers alike, it remains imperative to continue to study these interactions and further our understanding of them. In doing so, we should not ignore issues of inequality.
2. Faced with complex problems, we can achieve a lot by correcting erroneous beliefs. Our reality is complex, so we should not attempt to present it in an oversimplified manner. Politicians and other experts are thus reminded of their responsibility to inform the public, especially on matters that are complicated.

These are all reasons not to question the entire project at sight of simplistic alternatives. Instead, we need to search for convincing, long-term solutions.

Thank you.

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[1] Source: Penn World Tables Version 8.1.

[2] Source: Milanovic, B. (2013). Global income inequality in numbers: In history and now. Global policy, 4(2), 198–208.

[3] On domestic distributional consequences of international trade, see e.g. Acemoglu et al. (2016). Import competition and the great US employment sag of the 2000s. Journal of Labor Economics 34(S1): 141–198; McKinsey (2016), Poorer than their parents? A new perspective on income inequality. Available online: www.mckinsey.com/global-themes/employment-and-growth/poorer-than-their-parents-a-new-perspective-on-income-inequality.