Andreas Dombret: Quo vadis euro area? Challenges facing monetary union

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, to the CDU Economic Council, Berlin, 20 October 2011.

*   *   *

1 Introduction

Ladies and gentlemen,

Thank you very much for your invitation – I am delighted to be able to speak to you today. For more than four years now, we have been plagued by a crisis that has changed its appearance on a number of occasions. It spread from the US property market to the global financial system, from there to the real economy, leading finally to a sovereign debt crisis in several euro area countries. A sovereign debt crisis – let me emphasise this explicitly – that is a severe test for monetary union, but is not a crisis of the euro. The euro is a stable currency, both internally and externally.

Politicians are at pains to resolve the crisis, yet a consistent approach has been lacking to date. Meanwhile, we are losing valuable time and, given the rapidly rising levels of sovereign debt, politicians' scope for action is steadily shrinking. At the same time, uncertainty is growing on the markets around the globe and the confidence of the general public is at risk of becoming lost. This makes it all the more important to find a consistent approach to resolving the crisis in order to restore calm to the markets and to maintain the public's confidence in the single currency. In looking for such a solution approach, one that will stabilise monetary union also in the long term, it is worth taking a brief look at the root causes of the current crisis.

2 The causes of the sovereign debt crisis – a brief overview

It is generally known that there were unsound economic developments in a number of euro area member countries. Above all, these included excessive lending, asset price bubbles and a loss of competitiveness. These structural shortcomings were the breeding ground for the sovereign debt crisis.

However, two fundamental problems are directly responsible for the sovereign debt crisis. First, the institutional framework of monetary union was obviously too weak to prevent excessive fiscal deficits. The Stability and Growth Pact lays down rules that are intended to restrict government deficits and sovereign debt. The political will to enforce these rules was lacking, however. Instead, they were circumvented and, in some cases, even actively bent. Sovereign debt in the euro area could not be contained as a result.

Second, there were weaknesses in the financial system. This applies, on the one hand, to investors' risk awareness. For example, before the crisis, they demanded very low risk premiums from the euro area countries across the board. Their risk awareness did not increase until the problems in Greece became apparent. On the other hand, this also applies to the possible spread of the sovereign debt crisis via vulnerable banking systems. It was this very problem of contagion that made rescue measures necessary in the first place. Up until now, aid to Greece has always been justified by the objective of ensuring financial stability throughout the euro area. The bottom line is that public finances also benefit from stable financial systems, because they produce fewer crises that might necessitate government rescue measures.

Thus, in order to get the sovereign debt crisis under control and create a stable monetary union, the financial system needs to be strengthened and the institutional framework of European Monetary Union improved.

3 A stable financial system for a stable monetary union

Of course, strengthening the financial system is an important task, irrespective of the sovereign debt crisis. Since the financial and economic crisis at the latest, creating a stable and resilient financial system is a matter of global concern. In fact, a number of improvements have already been made in this context. Basel III has been approved, entailing extensive new rules for banks. The new capital and liquidity requirements in particular will make the banking system more stable. What is important now is to implement these new rules at global and at European level.

Yet even though much has already been achieved with Basel III, a great deal remains to be done. Problem areas at the moment include special rules for systemically important banks and the treatment of previously unregulated segments of the financial system, namely the shadow banking system. Suggestions have been made in the meantime, which will be discussed at the forthcoming G20 summit at the beginning of November. My impression of the meeting of the G20 in Paris last weekend is: on the whole, we are on the right path.

And we should not use up our energy on projects that might divert us from that path. In my opinion, one such project is the financial transaction tax; for in terms of financial stability, the benefit of such a tax is less clear-cut than assumed, whilst the debate often fails to take the costs and side-effects into consideration. It is quite possible that a financial transaction tax may heighten rather than reduce the volatility of the markets. Moreover, two factors cast doubt on the effectiveness of a financial transaction tax. First, profit expectations and the risk of loss are so high in times of crisis that not even a tax is likely to curb speculative transactions very much. Second, such a tax would only really be effective if it were introduced worldwide. We certainly cannot expect that to happen. Even if such a tax were introduced at EU level, which is more than unlikely, competition with countries outside the EU would be distorted as a result. The ensuing costs would then be borne not by the financial sector but by the real economy.

4 Two paths to a stable monetary union

A stable financial system, then, is a cornerstone of a stable monetary union. Yet to get to the heart of the problems, European Monetary Union itself needs to be reformed. Essentially, there are two paths to a stable monetary union: the first is by strengthening the institutional framework currently in place – a strengthening that must go well beyond what has been achieved to date; the second path lies in centralising fiscal policy – in other words: fiscal union.

4.1 Strengthening the existing institutional framework

With regard to the first path, I do not share the frequently expressed fear that the present framework is unsuitable for a monetary union. Nevertheless, there is, of course, considerable need for adjustment. This is true of three points in particular.

- First, the no bail-out principle has to be expressly reaffirmed. Investors in the financial markets will sanction misguided fiscal policy in a timely fashion only if they stand to lose money if they do not. Of course, this presupposes that the regulation of the financial markets offers incentives for risk-conscious behaviour.
- Second, the Stability and Growth Pact must be given “teeth”. There needs to be a much greater automatism in the Stability and Growth Pact for imposing sanctions

when the deficit and debt limits are breached. Yet this is precisely what is missing from the latest resolutions aimed at reforming the Pact. The automatism does not yet go far enough in my view – there are still too many exceptions and too much scope for political interference. To paraphrase Otmar Issing, sinners are still passing judgment on other sinners. In principle, the Pact has been given "more bite", but it remains questionable whether politicians will let it off the leash when push comes to shove.

- Third, monetary union needs a permanent crisis mechanism, which could be brought into play in the event of a crisis that threatens financial stability throughout the euro area. However, three points are crucial in this context. Financial assistance for individual countries must be tied to strict economic and fiscal policy conditions; assistance must be made subject to appropriate interest rate premiums; and private creditors must be involved should the country in question default. Above all, a crisis mechanism must not be used to brush aside important principles under the smokescreen of safeguarding financial stability. These principles include subsidiarity, individual countries' responsibility for their own fiscal policy and the no bail-out principle I have just mentioned.

Against this backdrop, a critical view has to be taken of at least some elements of the decisions taken recently by the euro area's heads of state or government. Allow me to mention three problems.

- The first problematic aspect is that conditions for granting emergency loans were loosened. In the meantime, they are more favourable than those borne by some of the countries providing assistance when they tap the capital market. But the less a country has to pay for assistance, the smaller, of course, is its incentive to consolidate its public finances and return to the capital markets. Adopting these conditions also for future aid programmes or even for the permanent crisis mechanism would perpetuate the problem. This cannot be our objective.
- A second problem is that government bonds may be purchased on the secondary market through the crisis mechanism in future. If bonds of countries without an assistance programme are purchased, it is unclear how consolidation and reform conditions can be enforced. Nor is it clear how this squares with the requirement that assistance can only be granted if the stability of the entire euro area is under threat. Ultimately, therefore, the possibility of secondary market purchases undermines the incentives to pursue a sound budgetary policy. Moreover, one point is often overlooked: secondary market purchases are a very crude and, indeed, a rather ineffective instrument for stabilising the financial markets and influencing countries' funding conditions. Thus, much larger amounts will be needed to achieve a particular result. This increases the risk for the taxpayers of the countries providing assistance.
- A third problem is the topic currently under discussion, that of leveraging the crisis mechanism – which is to say, first of all, a leveraging of the EFSF. Proposals of this kind are closely linked to the topic of secondary market purchases; for, since its recently approved extension, the EFSF has sufficient funds for the classical instruments of the rescue shield – direct emergency loans to individual member states. However, all the parties concerned ought to realise one thing. Leverage constructions increase the risk for the taxpayer – the relationship between leverage and risk is one of the first lessons from the financial crisis. What in any case must be rejected is a leveraging by granting the EFSF a banking licence, which would allow the EFSF to engage in Eurosystem refinancing operations – in other words, to borrow directly from central banks. For then, the Eurosystem would largely be unable to shape monetary policy autonomously. Indeed, the EFSF would be able to generate a virtually unlimited flow of funds to the capital markets and shift risks

around between member states by purchasing large quantities of sovereign bonds. With that, the ban on monetary state financing set forth in the EU treaties would be well and truly violated.

Overall, the question that presents itself is: how is a sanction mechanism – no matter how severe – in the Stability and Growth Pact supposed to prevent unsound fiscal policy if threats of sanctions are made, yet favourable conditions are lavished on a country that continuously disregards the rules?

This is a question of fundamental importance to monetary union. Whether the answer proves convincing will depend on what appear to be purely technical aspects of the solution, since they can have unexpected implications. One example concerns the choice of a triple-A rating for the bonds with which the EFSF rescue fund borrows money on the capital market for the assistance programmes. This top rating ought to remain intact as long as the borrowing by the EFSF does not exceed the guarantee amount of the liable countries that are triple-A rated. Thus, the effective lending volume currently amounts to €440 billion. In connection with the call for additional funds for the EFSF, insistence on this top rating for EFSF bonds leads, however, to the problematic leverage proposals I mentioned earlier. On the other hand, abandoning the triple-A rating would also enable the EFSF to lift its lending volume. With regard to the EFSF in its present form, it was reported that the lending volume of around €250 billion could have been increased by just over half if an AA rating had been accepted instead of triple A. In contrast to a leveraging, however, the risk borne by the taxpayer would be lower if the top rating were dispensed with. If the EFSF bonds had a somewhat lower rating, the effect would be to raise the EFSF's funding costs somewhat. However, these costs would be borne by the countries receiving assistance. This would solve, at least in part, the problem entailed in loosening the conditions for emergency loans and raise the incentive for countries to return to the capital market under their own steam.

To sum up: in my view, strengthening the existing regulatory framework is a feasible path towards stabilising monetary union. However, that will work only if the rules are designed in such a way that they do not leave the door wide open for misguided incentives. This applies in particular to the crisis mechanism – both at the conceptual level and in terms of the technical implementation. All too often, the devil is in the detail, and we cannot afford to make any mistakes there.

4.2 Creating a fiscal union

The alternative, second path towards a stable monetary union is by way of a fiscal union. This would not automatically lead to a completely centralised fiscal policy. But it would be important to set, at EU level, strict deficit and debt limits for national budgets. These limits would then apply at all national levels. In Germany, this means central, state and local government and the social security systems. The European rules would have to be combined with appropriate powers of intervention, as only then can the rules be effectively implemented. If the national levels breach the stipulated deficit and borrowing limits, they would have to forfeit their fiscal sovereignty. The final decision-making powers over budgets would then no longer rest with the national parliaments but would be transferred to the European level.

Ultimately, fiscal union would constitute a consistent framework for the single currency, although to implement it would necessitate extensive changes to the European treaties and national constitutions. As you can imagine, this route would be a long one, and there is no telling whether the people of the euro area would support it.

And to make one point quite clear: a fiscal union of this kind could, in principle, work without joint liability. Although joint liability could be introduced without much difficulty, it does not have to be. On no account – this is my firm belief – should joint liability be introduced at this point in time in mere anticipation of fiscal union. This would be taking the second step before the first, and inevitably entail the risk of stumbling. Instead of offering a consistent solution,

this would mean pursuing a middle path on which liability would be increasingly communitised while fiscal policy remains a national responsibility. That path entails obvious contradictions; for this reason, the Deutsche Bundesbank recommends we shun such an approach.

5 Conclusion

Ladies and gentlemen, we find ourselves in a situation in which difficult and, perhaps, uncomfortable decisions are unavoidable. This situation is aggravated by uncertainty in the markets and among the general public. This uncertainty has to be eliminated if we want to break free of the present crisis. Yet this uncertainty cannot be eliminated by repeatedly topping up the rescue fund. Instead, what we need are decisions which address the root causes of the crisis. Besides a swift and ambitious fiscal consolidation, I would highlight three main points.

- We need clarity regarding Greece's future. Greece must fulfil the conditions of the aid programme; if it does not, there is no basis for granting further support. A Greek default – which most certainly no-one wishes to see – cannot therefore be categorically ruled out.
- We need clarity regarding the banking sector's resilience. It has to be strengthened where it is too low in order to prevent contagion effects. This explicitly includes recapitalisations. This is justified even though the banks are not to blame for the high level of sovereign debt in several European peripheral countries.
- And we need clarity regarding the future of the monetary union. I have outlined two different paths in my address. Which of the two paths is chosen is in the hands of our politicians. It is now up to them to decide quickly. We therefore expect clear and landmark decisions by the European Council this coming Sunday.