# Andreas Dombret: Towards a more sustainable Europe

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Euromoney Germany Conference, Berlin, 25 April 2012.

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## 1 Introduction

Ladies and Gentlemen

I am delighted to have the opportunity to speak to you today at the Euromoney Germany conference. Now in its 8th year, the conference has established itself as a first-class opportunity for policymakers and financial practitioners to exchange views. I firmly believe that this free flow of ideas is of benefit to us all, and I am looking forward to sharing my views with you in the next 20 minutes.

We are facing a crisis that is no longer confined to individual countries. Throughout and beyond Europe, it weighs heavily on people's minds. Some believe, it even challenges the viability of monetary union in its current form. Given the exceptional scale and scope of the crisis, it is hardly surprising that views diverge on how to overcome it. But it is worth recalling that despite intense debates on the best way forward, we share a common vision for the future of our monetary union: a sound currency, sound public finances, competitive economies, and a stable financial system.

These are the principles enshrined in the Maastricht Treaty. With the adoption of the treaty, all euro-area member states committed to a European stability culture. Among those most eager to join were the countries with first-hand experience of the painful consequences of deficits spiralling out of control and of a monetary policy not always fully committed to maintaining price stability.

The unholy "marriage" between Banca d'Italia and the Italian treasury in 1975 is a perfect example. Banca d'Italia vowed to act as buyer of last resort for government bonds. Up to the "divorce" in 1981, Italian government debt more than tripled while average inflation stood at 17%. After Banca d'Italia was granted greater independence, inflation rates began to fall significantly.

The principles of a sound currency, sound public finances and a competitive economy thus remain the cornerstones of a strong and sustainable monetary union. Far from being a specifically German conviction, they serve the well-being of citizens throughout the euro area. And the ongoing validity of these principles is a prerequisite for the public acceptance of monetary union. Thus, any approach that does not respect and comply with these principles will not bring about a lasting solution to the crisis.

The current crisis is not a crisis of the euro as our common currency. Since the start of the euro, inflation has been in line with the Eurosystem's definition of price stability, and the euro continues to be a strong currency – to some, it actually appears to be too strong. But it is generally accepted that the two central elements of the crisis are large macroeconomic imbalances stemming from diverging competitiveness levels, and unsustainable levels of public debt.

## 2 The root causes of the crisis: macroeconomic imbalances and over-indebtedness

No lasting solution to the crisis will be achieved unless these root causes are tackled. Firewalls can help some countries to cope better with the effects of sudden shifts in investor sentiment, but, ultimately, all it can do is buy time. As the IMF points out in its recent World

Economic Outlook , firewalls by themselves cannot solve the difficult fiscal, competitiveness and growth issues that some countries are now facing.

### *2.1 Macroeconomic imbalances*

There is broad consensus that macroeconomic imbalances, which have built up in recent years, lie at the heart of the crisis. But the best way to correct these imbalances has been the subject of intense debate.

Exchange rate movements are usually an important channel through which unsustainable current account positions are corrected – deficit countries eventually see a devaluation, while surplus tend to revalue their currencies. The reactions that this triggers in imports, exports and corresponding capital flows then help to bring the current account back closer to balance.

In a monetary union, however, this is obviously no longer an option. Spain no longer has a peseta to devalue; Germany no longer has a deutsche mark to revalue. Other things must therefore give instead: prices, wages, employment and output.

The question now is which countries have to shoulder the adjustment burden. Naturally, this is where opinions start to differ.

The German position could be described as follows: the deficit countries must adjust. They must address their structural problems, reduce domestic demand, become more competitive and increase their exports.

But this position has not gone uncontested. Indeed, well-known commentators suggest that surplus countries should bear part of the adjustment burden in order to avoid deflation in deficit countries. They also point out that not all countries can act like Germany, in other words, not all countries can run a current account surplus. Hence, they suggest that surplus countries should shoulder at least part of the burden.

But this criticism misses the point of what the correction of domestic imbalances actually means:

As regards the lingering threat of a protracted deflation, it is rather a one-off reduction of prices and wages that is required, not a lasting deflationary process. In fact, frontloading reforms and necessary adjustment has proven to be more successful than protracted adjustment, as experience in the Baltic states and Ireland shows.

And while not all countries can run a current account surplus, all can become more competitive – higher competitiveness due to productivity increases or lower monopoly rents in, up to now, overregulated sectors is not a zero sum game. Structural reforms can unlock the potential to increase productivity and thus improve competitiveness without inducing deflation.

There is no way around the fact that Europe is part of a globalised world. And, at the global level, we are competing with economies such as the United States or China. To succeed, Europe as a whole has to become more dynamic, more inventive and more productive.

Once the deficit countries start to become more competitive, surplus countries will adjust automatically. They will become less competitive in relative terms, exporting less and importing more. And we should acknowledge that this process has already been set in motion. Exports of a number of peripheral countries have started to grow, bringing down current account deficits in the process. Correspondingly, German imports from the euro area have grown strongly over the last two years, almost halving the current account surplus between 2007 and 2011.

To facilitate the adjustment process, euro area members have committed significant funds within the framework of the EFSF and the ESM. Germany is contributing the biggest share.

This support is based on the high reputation Germany enjoys among investors. We would put this trust in jeopardy if we were to give in to calls for fiscal stimulus in Germany in order to raise demand for imports from the peripheral euro area. But weakening Germany's fiscal position would lead to higher refinancing costs and, therefore, either reduce the capacity of the firewalls or raise the borrowing costs for programme countries.

Moreover, studies by the IMF suggest that positive spill-over effects from an increase in German demand to partner countries in the euro area would be minimal. So, instead of stimulating exports in peripheral euro-area countries, additional fiscal stimulus at a time when Germany's economy is already running at normal capacity would be of detriment to all parties.

### 2.2 Fiscal consolidation

Turning to fiscal consolidation, it is often stressed that such measures, together with structural reforms, would be too much of a burden. They would create a vicious circle of decreasing demand and further budget pressure that would eventually bring the economy down. But to the extent that the current output level was fuelled by an unsustainable ballooning of private and public debt, correction as such is unavoidable, and the only question that remains is that of the best timing.

However, this crisis is a crisis of confidence. While, under normal circumstances, consolidation might dampen the economy, the lack of trust in public finances and in policymakers" willingness to act is a huge burden for growth. Thus, frontloaded, and therefore credible, consolidation would instead strengthen confidence, actually help the economy to grow and reduce the danger of the crisis spreading to the financial system.

In addition, urgently needed structural reforms and consolidation are often hard to disentangle. For example, a bloated public sector or very generous pension system are both a drag on growth and a burden on the budget. The same applies to inefficient companies that are state-owned or operate in highly regulated sectors.

The risks to growth emanating from immediate fiscal consolidation therefore have to be put into perspective. Negative short-term effects cannot be ruled out. But to the extent that consolidation constitutes necessary corrections of an unsustainable development and brings about greater efficiency, the long-term gains do not only vastly exceed potential short-term pain, they also help to alleviate it now by restoring the lost credibility in the ability to tackle the root causes of the crisis.

## 3 The role of monetary policy

Up to now, the picture has been mixed in this regard. We have seen substantial progress, often initiated by new, more reform-minded governments, but also some setbacks. A much clearer pattern has emerged with respect to the expectations placed on monetary policy. Whenever a new intensification of the crisis looms, the first question seems to be "What can the central banks do about this?" To me, this is a worrisome development.

Monetary policy has already gone a very long way towards containing the crisis. But we have to be aware that the medicine of a very low interest rate policy, ample provision of liquidity at very favourable conditions and large-scale financial market intervention does not come without side effects – which are all the more severe, the longer the drug is administered.

In the course of this crisis, the role of central banks has changed fundamentally. Before the crisis, they provided scarce liquidity; now they increasing serve as a regular source of funding for banks, and this threatens to replace or displace private investors. This may give rise to new financial instability if, as a result of the measures, banks and investors behave carelessly or embark on unsustainable business models, for instance, due to substantial carry trades.

But emergency measures will not become the “new normal”. Banks, investors and governments have to be fully aware of this, and central banks cannot tolerate that their well-intentioned emergency measures result in a delay in necessary adjustments in the financial sector or protracted consolidation and reform efforts among governments.

## 4 Conclusion

Ladies and Gentlemen

In my remarks, I have focused on necessary reforms in the euro area member states. This is not to say that changes to the institutional set-up of monetary union are not important. If member states want to retain autonomy with regard to fiscal policy, we need stricter rules to account for the incentives to accumulate debt that exist in a monetary union. The fiscal compact is a promising step forward. Now, it is essential that the rules are applied rigorously.

Referring to the motto of this conference “A German Europe or a European Germany”, how should one label the recipe to overcome the crisis that I have just presented? Well, it is, quite obviously, a European solution. And that is because it fully reflects and respects the letter as well as the spirit of the European Treaty and therefore of the principles that I stressed at the beginning. The current crisis is most certainly a defining moment for monetary union. But the crisis and the measures taken to overcome it should not be allowed to redefine implicitly what monetary union actually is.

This time we really cannot “let this crisis go to waste”, as the former White House chief of staff, Rahm Emanuel, put it. The crisis has laid bare structural flaws at many levels. It has questioned the way we adhered to the principles of EMU, but did not invalidate the principles themselves, quite the contrary. I am confident that having stared into the abyss, Europe will make the right choices and pave the way for a more prosperous and sustainable future – to the benefit of Germany as well as of the euro area as a whole.