Andreas Dombret: The role of the state in the financial system

Dinner speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the ifo/ CESifo/ Bundesbank Conference, Munich, 14 September 2012.

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Of scientists and drivers

Ladies and gentlemen,

Please let me welcome you to tonight's conference dinner. Having discussed complex issues all day, you now really deserve the opportunity to socialise with one another.

But before you do so, and before we start enjoying our dinner, please let me tell you a short anecdote:

In 1919, the physicist Max Planck was awarded the Nobel Prize for his work on the quantum theory. As a consequence, he toured Germany, having to give countless speeches about quantum physics. It is said that he complained about these many talks to his driver. The driver therefore suggested:

> *"By now, I have heard your talk so often that I can give it myself. Why don't we change places? I'll pretend to be the physicist and give the talk while you pretend to be the driver."*

Next time, the driver gave the talk – and his performance was quite convincing – while Planck sat in the audience. All went well until someone from the audience posed a question. Naturally, the driver was unable to answer it. But instead of admitting this, he replied:

> *"Your question seems ridiculously easy to me. I believe, even my driver can answer your question."*

And his "chauffeur" did so.

Please, do not misunderstand me: Considering the first-class participants list of this conference and the high quality of the papers selected, I am convinced that the academics at this conference will speak with the authority of people who absolutely know their trade. I have no doubt whatsoever on this score.

However, I have to admit that when following the discussion in the media about the European debt crisis it is sometimes hard to separate the "drivers" from the real academics. I get the impression that everyone has an opinion on these topics – and that everyone has stated that opinion at least once.

Take, for instance, the discussion about a banking union in Europe. This topic has stirred – quite understandably, I may add – quite some unrest in the German economic community. Petitions were launched, and provocative counter-petitions were issued, in some cases endorsed by some of the exact same academics.

This seems striking, given that they were signed by well-respected academics. However, these petitions are perhaps not as incompatible as it might appear. Obviously, one comes to different conclusions if the reasoning is based on different assumptions. And the different assumptions stem from the various interpretations of the results of the European summit in June.

The core statements of the petitions about the banking union are not disputed. For me, these core statements are: "*There should not be unconditional collective accountability for the debts in the euro area*" and "*Banking supervision in Europe needs to be harmonised and improved.*" And although not everybody may agree with the style and details of the different petitions, most people probably concur with these two main messages. I, for my part, concur with both statements.

Both messages are related to a question which is central in economics – and which is also a topic for our conference: What role should we assign to the state? And what role should markets play?

The Role of the state

Ten or even five years ago, the opinion in the academic world was relatively unanimous with respect to the role of the state in the banking sector: The state and regulators were seen as an obstacle to economic growth, and state-owned banks were perceived as the flotsam and jetsam of free market economies. "*Let the market deal with the issues of the financial sector, and capital and risks will be efficiently allocated,*" most academics argued. A saying attributed to the well-respected former Bavarian prime minister Franz-Josef Strauss comes to mind: "*A dog is more likely to put away a sausage for a rainy day than the state is to save money.*"

Then came the financial crisis. The distrust in the state among mainstream academics has remained. However, there is now distrust in markets as well, perhaps surpassing distrust in the state. In the academic community and the media, there has been a debate about excessive bonuses for bankers, about distorted incentives for risk-taking in banks and, last but not least, about the role of rating agencies.

To my mind, the crisis has shown that, like it or not, the state is needed as the ultimate guarantor of systemically important functions of the banking sector. In a systemic crisis, deposit insurance schemes can succeed only if the state, and thus the taxpayer, credibly guarantees the liabilities, as illustrated, for example, by the TV appearance by Chancellor Merkel and Finance Minister Steinbrück in 2008, in which they guaranteed all banking deposits in Germany.

At that time there were fears of a self-fulfilling run on private deposits – clearly a case of market failure – which were discussed at length in economic literature. So there was a good reason for government to step in. The government also had the power to impose restrictions on the banks' actions, if necessary. And the unity of liability and control represents an important condition to limit the moral hazard implications of such a guarantee.

Another example is the international discussion on large banks. Due to their systemic importance and interconnectedness, no state can afford to let them descend into disorderly default. Therefore, resolution regimes are currently being discussed by international fora, so that, in principle, also large banks can exit the market without causing systemic disruptions. In this respect, i.e. by establishing a clear framework to limit financial stability risks, I believe the state has its role. This is exactly where regulation comes in: An appropriate, internationally harmonised regulation as well as resolution schemes endeavour to ensure that "too-big-to-fail" banks do not abuse their status.

There are some parallels between these considerations and the challenges of the debt crisis. Nowadays, views such as: "*Markets help to discipline fiscal policies, which is what we urgently need to resolve the crisis*" do not seem to be very popular. However, popular or not, what matters is whether or not this statement is true. It may well not be true all the time. However, to me there seems to be more truth in this view than in many so-called "solutions" implying ever-increasing unconditional financial "assistance". Many of these proposals ignore moral hazard implications and might therefore simply postpone solutions. They might even increase the problems they are meant to tackle in the long run.

Financial assistance is necessary to buy time – nothing more and nothing less. It cannot be a long-term solution. Such a long-term solution can only be achieved through fiscal consolidation and structural reforms.

As with banks, we cannot ignore or deny the systemic importance of certain countries within the euro area. And in the same manner, it is vital to ensure that politicians cannot use this status to delay necessary steps simply because these steps are unpopular.

To reach an appropriate assessment, it is also essential to know whether we are currently still in a situation in which markets can successfully exercise their disciplinary powers – or whether we already have moved to a full-blown systemic crisis in which the threat of self-fulfilling downward spirals calls for massive intervention.

But even if this were the case – and let me make this very clear – it would be up to democratically elected governments, and not up to central banks, to take the necessary action. Central banks can give advice – but only governments have the authority, conferred by their democratic legitimacy, to make changes to regulatory systems.

I am sure that the programme of this conference so far has provided enough material for interesting discussions tonight and for the rest of what will undoubtedly be a fruitful, productive and successful conference tomorrow.