Andreas Dombret: As goes Ireland, so goes Europe?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Institute of International and European Affairs, Dublin, 25 October 2012.

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1. Introduction

Ladies and Gentlemen

Many thanks for inviting me to speak to you. I am delighted to have the opportunity to be with you here in Dublin today.

One of the issues which the *Institute of International and European Affairs* features on its website is "The Future of Europe". And, indeed, the future of Europe is at the centre of the current public debate.

After nearly ten very successful years, the European Monetary Union has encountered a serious crisis. Over the past few months, we have seen some progress in this regard: a fiscal compact has been agreed, the ESM has come to life, there is preliminary agreement on a European Single Supervisory Mechanism, and – most importantly – more member states of the euro area have embarked on broader economic reforms. But the crisis is still not over, and progress is still too often painfully slow.

When talking about the euro, the successes, the setbacks and the way forward, Ireland plays an important role. As an open and flexible economy with a highly skilled work force, Ireland has seized the opportunities presented by global and especially by European economic integration.

When Ireland joined the EU in 1973, it was one of the poorer member states. Since then, your real per capita income has increased more than twofold and is today among the highest in the euro area. Ireland has benefited from several factors: low barriers in terms of language and culture vis à vis the US and the UK have certainly helped, but Ireland also has done a lot to raise its growth potential by improving the skills of its labour force, lowering corporate taxes and maintaining flexible labour and product markets. As a result, you attracted a lot of Foreign Direct Investment and became a remarkably open economy.

As we all know, this remarkable success story has suffered a number of setbacks. In the light of the crisis, some economic developments have proved unsustainable. The Irish real estate boom – as so many others – provided a temporary boost at the time, but raised private debt to worrying levels – to 215 % of GDP in 2007 – and diverted capital away from potentially more productive uses. Exploding unit labour costs have eroded the competitiveness of the Irish economy, undermining the very core of its growth model so far.

But even though the last few years have been challenging, many signs point to a silver lining. There has been significant progress in reforms with the results to show for it: on-track deficit reduction, falling unit labour costs, a positive current account and last but not least a return to positive growth. To sum it up: I am very much confident with regard to the Irish case.

And I am more and more convinced that we are witnessing a resurgence that is instructive for the euro area as a whole. The problems experienced by Ireland are by no means confined to the "Green Island", but are typical of what went wrong in the run-up to the crisis. Thus, the reforms undertaken in Ireland hold valuable lessons for the wider monetary union.

But what exactly did go wrong at the onset of EMU?

2. The origins of the crisis

For many euro-area member states, the introduction of the euro ushered in a new era of abundant capital. In the case of Ireland, for instance, capital inflows amounted to about two trillion euro between 1999 and 2008. In principle, this is exactly what standard economic reasoning predicts: capital was flowing from capital-rich to capital-poor economies, where returns should be higher. Such flows complemented limited domestic saving in capital-poor countries and reduced their cost of capital, boosting investment and growth.

As we all know, it did not always work that way. Overblown financial sectors channeled the capital flows into unproductive investments. Ireland is certainly a case in point as light-touch regulation and tax incentives encouraged the financial sector to balloon. Overinvestment in real estate as well as in public and private consumption failed to boost productivity. Unit labour costs soared, competitiveness declined, and rigid labour and product markets meant that this process gained additional momentum.

When the financial crisis broke out in 2007, the vulnerabilities became apparent in Ireland. Growth imploded, deficits – which were often already too high before the crisis – exploded, and cracks in the Irish banking system started to show. As an aside, you may recall that these cracks extended right into Germany, where Irish subsidiaries or special investment vehicles got their German parent companies into trouble. Not surprisingly, investor sentiment began to shift, and also interest rates in your country started to rise sharply, triggering a major crisis that is still far from being resolved.

How could it all go so wrong? Key to understanding the crisis is the euro area's unique institutional set-up, a set-up that easily leads to simple, but faulty analogies with other economies.

As you are well aware the euro area pairs a common monetary policy with 17 national fiscal policies. Firstly, this combination gives rise to a deficit bias, as it allows costs to be shifted partially on to others. If a worsening fiscal position in one country has repercussions for our monetary union as a whole, others may step in and bail out. And, secondly, central banks' balance sheets can serve as a conduit for shifting risks among national taxpayers, even if there are no explicit fiscal transfers.

The founding fathers of the euro foresaw this risk. Precautions were taken in the form of the prohibition of monetary financing of government deficits, price stability as the primary objective, the no-bail-out clause and the Stability and Growth Pact that was to give teeth to the rules on sound public finances enshrined in the Maastricht Treaty. However, the fiscal rules were breached numerous times, not least by Germany and France. In addition, investors made hardly any distinction between the bonds of individual member states – I leave it to you to decide whether this was because they neglected the growing differences in the economic fundamentals or because they never really believed that the no-bail-out clause would hold once the going got tough.

While the provisions against unstable fiscal positions proved to be insufficient, the institutional framework took no account of other macroeconomic imbalances. Risks stemming from divergences in competitiveness or exaggerations in national real estate sectors were not considered in the design of the European Monetary Union. Hence, even countries that had impressive fiscal data before the crisis ran into deep trouble once the enormous implicit liabilities in their banking sectors became apparent.

Ireland, unfortunately, was one of those countries. Assessing the Irish economy in 2007 the IMF – which I quote for convenience, not to blame it – wrote: "Fiscal policy has been prudent, with a medium-term fiscal objective of close to balance or surplus, in line with Fund advice. In the past couple [of] years, windfall property-related revenues were saved and the fiscal stance was not procyclical, in line with Fund advice". However, once the risks in the financial sector materialised and the government had to step in, Irelands fiscal position deteriorated very quickly.

3. The way forward

To overcome the current crisis, and to prevent future crises, we have to address these problems I have just described. And this has to happen both nationally and at the European level.

So far, a number of steps have been taken. At the beginning of my speech I mentioned the ESM, to which I might add the fiscal compact and the new excessive imbalance procedure that has been established to prevent macroeconomic developments from diverging too much in the future. Nevertheless, the painful task of correcting past mistakes lies mainly with the member states. In this context I wish to point to Ireland as a good example of what has to be done and what can be achieved. In this regard I view Ireland as a "role model of the periphery".

I have already mentioned the decline in competitiveness that occurred prior to the crisis. In this respect Ireland certainly had a steep mountain to climb. In 2008, Irish unit labour costs, as an indicator of competitiveness, were more than 40% higher than at the launch of EMU. Still, not least thanks to flexible labour markets, the necessary adjustment has been swifter in Ireland than in other member states.

There was a similar experience with the bubble in the Irish real estate market. Your problems became apparent earlier than in other member states, with property prices starting to fall in the last quarter of 2007. Hence, Ireland responded earlier than other countries, and in a determined manner, to a shock which, as of today, has cut property prices in half. As a result, the restructuring of the banking sector is more advanced and costs for bank loans to firms are now lower than in countries such as Italy or Spain. This highlights the fact that it is sometimes better to take a big bath rather than just a shower. And it is better to take it as soon as possible because the water typically gets colder as time passes by.

But the situation in your country also highlights something else: the dangerous link between banks and sovereigns. Looking to the future, this link has to be broken, or at least to be weakened considerably, to prevent history from repeating itself.

Let me first step back and take a look at why the close link between banks and sovereigns has proven to be so problematic and so dangerous in this crisis. If many banks run into trouble at the same time, possibly on account of a large asset bubble bursting, financial stability as a whole is threatened. The government then often has no option but to step in if it wants to prevent a meltdown of the real economy. But such a rescue can place a huge burden on government finances – and no country knows that better than Ireland, where support for the financial sector was a major factor why the debt ratio soared from 25% of GDP in 2007 to 108% in 2011. Conversely, weak government finances can destabilise banks – directly through their exposure to sovereign bonds, and, indirectly, through worsening macroeconomic conditions. That is what we are also witnessing at this very moment.

Thus, breaking the link between banks and sovereigns is vital for making the euro area more stable. A banking union can very well be a major step in that direction – but by harnessing the disciplinary forces of the market, not by doing away with them. Core elements of a banking union therefore have to be: First, a comprehensive bail-in of bank creditors, and second, an appropriate risk-weighting of sovereign bonds.

In order to minimise the risk that bank rescues pose to government finances, creditors have to be the first in line when it comes to bearing banks' losses. Implicit guarantees have to be removed as taxpayers' money can only be the last resort. By the same token, sovereign bonds need to be risk-weighted appropriately when it comes to the adequacy of capital buffers. Riskier bonds have to become more expensive in terms of the amount of equity that they tie down, as is already the case for non-sovereign bonds. This serves two purposes: On the one hand, surcharges of this kind should translate into lower demand and, hence, into larger spreads, which gives a disciplining signal to the respective sovereign. And, on the other hand, banks would become more resilient in the event of market turmoil.

Adequate risk-weighting of sovereign bonds helps to prevent fiscal difficulties from translating directly into financial instability. If fiscal autonomy remains with national member states, which is still the status quo in the EU Treaties, this is crucial. Banks have to internalise the fiscal position of sovereigns in a similar manner as they take into account the risk of corporate bonds or loans. Otherwise, the envisaged recapitalisation of banks via European funds could turn out to be a backdoor for mutualising sovereign solvency risks.

I therefore believe that these two regulatory reforms – a comprehensive bail-in of creditors as well as an adequate risk-weighting of sovereign bonds – need to complement the envisaged European supervisory mechanism. In principle, this single European supervisor can help prevent future crises by enforcing the same high standards irrespective of the banks' country of origin and by taking transnational interdependencies into account.

At the moment, it looks as though this task shall be carried out by the European Central Bank. This is, first of all, an expression of confidence in the competence of central banks in general and in the ECB in particular. But conducting monetary policy and financial supervision does not come without risks. If the institution responsible for ensuring the financial soundness of banks simultaneously influences banks' financing conditions via its monetary policy, conflicts of interest may arise. Besides, the resolution of banks implies intervening in property rights, which requires democratic accountability. If the ECB is to be tasked with supervising European banks, there will have to be a strict separation of monetary policy and supervision. Such a separation will be difficult from both a legal and an organisational point of view. In this respect, there still are questions that need to be resolved.

A banking union will contribute to financial stability, if its design preserves sound incentives for all actors involved. This holds true not only for future risks, but also for risks that have already materialised. Economically speaking, a banking union is basically an insurance mechanism. And, as with any insurance, only future losses or damages that are unknown *ex ante* can be covered. No doubt, the banking union is an important building block for a more stable monetary union. But, as such, it is meant to mitigate future risks and not to cover past sins.

In this context, I fully understand that Ireland is closely following the conditions under which euro-area member states will provide financial assistance to Spain for the recapitalisation of its financial institutions. One specific point is the degree of bondholders' participation in the Spanish restructuring process. The Eurogroup stated in July with respect to Ireland: "Similar cases will be treated equally, taking into account changed circumstances." However, as this issue is currently under discussion I prefer abstaining from public comments. Instead I like to share my view with you on the issue of legacy assets in general.

Legacy assets are those risks which evolved under the responsibility of national supervisors. From what I have already said, it follows that these assets have to be dealt with by the respective member states. Anything else would amount to a fiscal transfer. It may be that such fiscal transfers are desired or even deemed necessary. But then, they should be conducted via national budgets and subject to approval of national parliaments, rather than under the guise of a banking union, which would then have to start under a heavy burden. And, in the event of such transfers the proper sequencing of events is the key. We should not end up in a world where risks from bank balance sheets are rapidly mutualised, while an effective single supervisory mechanism would be slow in coming.

A banking union will therefore not be a quick fix. But it can be an important milestone towards a more stable and prosper monetary union and hence instrumental in regaining confidence in the euro area.

Ireland has already come a long way in this regard, as your successful return to the capital markets in July has shown. Trust has been regained because Ireland has walked the talk. And I am sure you agree: Any deviation from this climb when the mountaintop is already in sight would be both short-sighted and costly.

More precisely, when listening to the discussion on more leniency for Greece, I can understand that demanding similar adjustments to the Irish programme seem tempting at first glance. But as we have learned the hard way over the last years, trust is as easily lost as it is hard to regain.

Ireland has made enormous progress in the process of regaining trust and confidence. Important financial market indicators are an expression of this fact. CDS premia for the Irish sovereign have fallen continuously in 2012. In the meantime Irish CDS premia are below those of Spain and even Italy. The same development can be observed for the spread over German bunds. All of these developments are the result of "leading by example" with structural reforms. Hence, I see no reason for Irish CDS changing the course, and I doubt that this would truly be in Ireland's best interest. I suggest not to jeopardise what has been achieved so far.

4. Conclusion

Ladies and gentlemen,

When we talk about Europe, Ireland is such an interesting example for a number of reasons. First, it highlights the benefits of a unified Europe which still leaves its member states enough room to establish their own model of success – Ireland has certainly seized that opportunity. But the Irish experience at the same time also illustrates some of the things that have gone wrong in Europe over the past decade, and I have mentioned many of them in my speech.

Nevertheless, and even more importantly, the Irish experience holds valuable lessons on how to overcome the current crisis. Of course, Ireland has not yet overcome all of its problems – every country is different and challenges are never exactly the same. But I believe we all can learn a great deal from the Irish way of handling the crisis: As goes Ireland, so goes Europe. Let me conclude my speech with the single most important and most encouraging lesson we can draw from the Irish experience: "Yes, it can be done".

Thank you for your attention.