Andreas Dombret: Speech at Columbia University – the current crisis, EMU and the euro

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at Columbia University, New York, 2 November 2012.

* * *

1. Introduction

Ladies and Gentlemen

I am delighted to have the opportunity to speak to you today. On this occasion, please let me express my deepest sympathies for the hardships New Yorkers are facing right now.

Columbia University's reputation for undertaking groundbreaking research is well deserved and that applies all the more to financial and economic matters. Over the years, many central bank decisions have been influenced by the work of Columbia researchers, and many people would argue that the very existence of the European Central Bank and the Eurosystem owes a great deal to the findings of Columbia economist Robert Mundell. His theory of optimum currency areas, on which scholars like Kenen, Frankel and Rose later expanded, provided the theoretical foundation for European Monetary Union.

There were high hopes that the euro would set in motion a process of lasting convergence among the member states. The crisis has put an end to these hopes being fulfilled, at least for the time being. And given the exceptional scale and scope of the crisis and the high degree of uncertainty we are currently experiencing, it is hardly surprising that there are diverging views on how to overcome it. But it seems to me that, even though views differ about crisis resolution, a consensus has emerged on how the crisis developed.

That might seem paradoxical at first: If there really is an agreed diagnosis of the causes, how is it that prescriptions for remedying the euro area's woes differ so starkly? In my remarks, I wish to argue that such differences of opinion are motivated largely by a constant tug-of-war between two competing economic objectives: Efficiency, in particular through proper incentives, on the one side, and distributional issues, on the other.

Or, to put it more bluntly, one line of argument is about how EMU's growth engine can be fixed and how it can be run more reliably, whereas the other line of argument is about who will foot the bill – for past and future burdens alike. Based on the diagnosis of how the crisis originated, I would argue that if EMU is not put on a sound footing that allows it to run better in the future, the objective of equity and redistribution will become self-defeating because there will be much less available to distribute.

So, let us first take a look at what went wrong in the run-up to the crisis.

2. The origins of the crisis

For many countries in Europe, the introduction of the euro, and therefore the elimination of exchange rate risks, ushered in a new era of abundant capital. In the case of Ireland, for instance, capital inflows amounted to about 2 trillion euros between 1999 and 2008. Qualitatively, this is exactly what standard economic reasoning predicts: Capital flows from capital-rich to capital-poor economies, where risk-adjusted returns should be higher. These flows complement limited domestic saving in capital-poor countries and reduce their cost of capital, boosting investment and growth.

As we know, it did not exactly work out like that. In some member countries, capital flows were put to unproductive use, as overinvestment in real estate as well as public and private consumption failed to raise productivity. Unit labour costs soared, competitiveness declined and, due to rigid labour and product markets, this process gained even more momentum.

When the financial crisis broke out in 2007, the vulnerabilities became apparent. Growth imploded, deficits – often already too high before the crisis – exploded, and cracks started to show in the banking system, implying possibly huge liabilities for the public sector. Not surprisingly, investor sentiment began to shift, and interest rates for the countries in question started to rise sharply, triggering a crisis that is still far from being resolved.

So how could things go so wrong? Key to understanding the crisis is the euro area's unique institutional set-up. Overlooking this set-up can easily lead to simplistic, but erroneous analogies being drawn with other economies. The euro area teams up a single monetary policy with 17 national fiscal and economic policies. On the one hand, this is one of the benefits of a unified Europe composed of peoples and nations which often have quite different backgrounds and cultures: member states retain enough room to preserve such diversity, that is, to establish their own model of success or to tailor institutions and policies to their own national preferences, for example, with respect to income redistribution or the role of the state in the economy.

On the other hand, this set-up also creates vulnerabilities. Firstly, such a combination creates 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 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 and irrespective of the approval of national legislatures.

The founding fathers of the euro clearly foresaw that 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 constraints on public finances enshrined in the Maastricht Treaty. But even as the assumption of sovereign debt was ruled out, 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. From 1999 to 2007 the average difference between EMU government bonds, excluding Germany and German government bonds, for instance, was a mere 14 Basis Points. I leave it to you to decide whether this was because investors were neglecting the growing differences in economic fundamentals or because they never really believed that the no-bail-out clause would hold when the going got tough.

While the provisions against unstable fiscal positions proved to be insufficient, the drafters of the institutional framework turned a blind eye to other macroeconomic imbalances of the type I have just mentioned – in other words, risks stemming from divergences in competitiveness, exaggerations in national real estate sectors and overblown financial systems. Hence, even countries such as Ireland or Spain that had impressive fiscal data before the crisis ran into deep trouble once the enormous implicit liabilities in their banking sectors became apparent. In that regard, the current crisis is not simply a sovereign debt crisis, but can also be seen as a balance of payments crisis, as the Bundesbank has just pointed out in its most recent Monthly Report.

3. The trade-off between sound incentives and burden sharing

To me, the diagnosis of the crisis I have presented so far seems to be largely uncontested. True, some would argue that there was a degree of complicity on the part of simple-minded or unscrupulous investors and of economies with persistent current account surpluses, but the main responsibility is seen as lying within the framework of EMU and the countries that are at the epicentre of the crisis. But then, what can explain the vast array of opinions on how to resolve the crisis?

As I said at the beginning of my speech, the debate runs along the front lines of one of the most well known trade-offs in economics: the trade-off between efficiency and distribution, or, put differently, between sound incentives and burden sharing. Such a trade-off informs the debate at the national level. For example, labour market reforms in the countries at the periphery would lower barriers to entry and hence promote employment, but incumbent employees are taking issue with such reforms because they fear downward pressures on wages or a greater risk of losing their jobs. And the trade-off informs the debate at the European level. On the one hand, there is the desire to strengthen incentives and controls in order to contain risks. On the other hand, there is the desire to share the economic, social and political burdens through mutualising risks. Such a tug-of-war between sound incentives and greater burden-sharing occurred in the debate on the construction of the rescue mechanisms, in the debate on introducing Eurobonds, in the debate on a true fiscal union, and now it takes place in the debate on a possible banking union.

The Bundesbank position in these debates has been clear and consistent. Sound incentives are indispensable for countering the biases inherent in the euro area's architecture. Some burden sharing is necessary, and it is implemented via the rescue mechanisms that grant financial assistance. But if burdens are shared in a manner that distorts incentives even further, no lasting resolution of the crisis will be possible. Studies by the Bundesbank have shown that, in the euro area, which may be interpreted as a particularly credible variant of fixed exchange rate regimes, usual adjustment mechanisms are less immediate and less harsh than in other exchange rate regimes. Through the convergence of short-term interest rates and the nearly unlimited provision of liquidity, the common monetary policy smoothes an otherwise more abrupt adjustment process, which would entail significant costs to the financial system and the real economy. But insofar as normal adjustment forces are suspended, sound incentives need to be put in place to bring about lasting gains in competitiveness and productivity. And given the dimension of existing inefficiencies, the current crisis of confidence and past experience of implementation lag and drag, there is no compelling argument for delaying the necessary adjustments while putting additional burden sharing first.

The hotly debated banking union is a good case in point. Let me first take a step back and take a look at why the close link between banks and sovereigns has proved to be so problematic during this crisis. If many banks get into trouble at the same time, possibly due to the burst of a large asset bubble, financial stability as a whole is threatened. The state 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 – this is what happened in Ireland, where the need to prop up the financial system pushed the deficit above 30% of GDP in 2010. Conversely, weak government positions can destabilise banks – directly through their exposure to sovereign bonds or indirectly through worsening macroeconomic conditions. That is also what we see right now.

Breaking the link between banks and sovereigns is vital to make the euro area more stable. A banking union can be a big step in that direction – but only if we harness the disciplinary forces of the market, not if we do away with them. Core elements of a banking union therefore have to be, first, a comprehensive bail-in of bank creditors, and second, an adequate risk-weighting of sovereign bonds in banks' balance sheets.

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 adequately risk-weighted 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 with non-sovereign bonds. This serves two purposes: Firstly, such surcharges should translate into lower demand and hence, larger spreads, which gives a disciplining signal to the respective sovereign. And, secondly, banks would become more resilient in cases of market turmoil. In addition, there should be caps on banks' maximum exposure to individual sovereign creditors, as is already the case with private creditors.

Such enhancements of the regulatory framework need to complement the envisaged European supervisory mechanism. In principle, this single European supervisor could help to 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 the ECB should carry out this task. This is, first of all, an expression of confidence in the competence of central banks. But conducting monetary policy and financial supervision does not come without risks. If the institution tasked with ensuring banks' financial soundness simultaneously influences their financing conditions through its monetary policy, conflicts of interest might arise. Besides restructuring, let alone closing down banks is an intervention into property rights which requires democratic accountability. If the ECB were really to be tasked with supervising European banks, there would have to be a strict separation of monetary policy and supervision. But such a separation is difficult, from both a legal and an organisational point of view. Here, many questions still need to be resolved.

A banking union will only contribute to financial stability if its design preserves sound incentives for all the actors involved. This holds true not only for future risks, but also for risks that have already materialised. After all, a banking union is also an insurance mechanism. And as with any insurance, only future loss or damage that is unknown ex ante should be covered. Therefore, the legacy assets, these are those risks which evolved under the responsibility of national supervisors 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 desirable or even deemed to be necessary. But then, they should be conducted through national budgets and be subject to the 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 being made, 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.

Getting the single supervisory mechanism and a common resolution and restructuring regime operational is a daunting task. Several conceptual issues have not yet been resolved. How do we deal with the ten EU members that do not belong to the euro area? What are the specific roles of the single supervisor and of the national supervisors who do the daily work in checking about 6,000 banks in the euro area? And even when these questions have been resolved, the legal preparations both at the European level and in the member states would be hugely demanding – as it is often the case with such large projects, the devil is in the detail.

I do not want to appear as an inveterate objectionist, even though the institution of which I am a representative is sometimes accused of that role. Rather, I am deeply convinced that Europe has to get this banking union project right and cannot afford a bumpy start. For this reason, too, a banking union will not be a quick fix for the current crisis. But it can be a major milestone towards a more stable and prosper monetary union and hence instrumental in re-establishing confidence in the euro area.

4. Conclusion

Ladies and gentlemen,

A lot went wrong in Europe over the past decade, and the crisis has revealed serious flaws in the euro area's architecture. Yes, some governments, enterprises, banks and households have wasted the opportunities presented by the euro, but the benefits clearly outweigh the excesses. According to a recent report on Europe's growth model published by the World Bank, one of Europe's most attractive features is that it is a "convergence machine". Simply by virtue of being European and enjoying the benefits of European integration, a European country has a better chance of moving to the top of the prosperity ladder than other countries in the world. But we need to get this machine running again, we need to make it strong again and make it more reliable. The task is daunting, often tedious and sometimes sobering. But I am convinced that it can be done and that, ultimately, we shall succeed. The monetary union and the euro are here to stay.

Thank you for your attention.