Andreas Dombret: The importance of being competitive

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the ESMT (European School of Management and Technology) Open Lecture, ESMT, Berlin, 20 February 2013.

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1. Introduction

Dear Professor Rocholl

Ladies and gentlemen

I am delighted to have the opportunity to speak to you today here at the ESMT. At the time, the decision to set up a private business school in an academic landscape dominated by public institutions met with a certain degree of scepticism. In this regard, ESMT was no different from most start-ups. But ten years later, the ESMT is doing rather well, and that is much less common among start-ups. Failure rates are high among young enterprises, but once the initial phase has been survived, a long period of robust health can be expected. Optimism is therefore warranted, and not just because the ESMT is entering its teens.

One of ESMT's main fields of study is in European competitiveness. The results of this research will hardly suffer from a lack of attention. It is now widely agreed upon that persistent gaps in competitiveness were one of the root causes of the current crisis. Recognising that fact certainly constitutes progress. Nevertheless, although a consensus appears to have emerged concerning how the crisis developed, views still differ on how it should be resolved.

That might seem somewhat paradoxical at first. If there really is a consensus that restoring competitiveness is key to overcoming the crisis, 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 have their origin largely in a constant tug-of-war between two competing economic objectives: efficiency, in particular motivated by the proper incentives, on the one hand, and distributional issues, on the other.

Or, to put it more bluntly, one line of argument has to do with how EMU's growth engine should be fixed and how it should be made to run more reliably, while the other line of argument is more about who is going to foot the bill – for past and future burdens alike. I do not want to disregard concerns about the scale of such burdens or the social and political costs of bearing them. Rather, based on a diagnosis of how the crisis came about, I would like to stress that, if EMU is not given sound foundations allowing it to function better in the future, the objectives of equity and redistribution will become self-defeating because there will be much less available to distribute.

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

The trade-off between equity and efficiency is at the centre of the debate at the national level. For example, labour market reforms in the countries at the periphery designed to lower barriers to entry and, hence, promote employment are being called into question by incumbent employees who fear downward pressure on wages and a higher risk of being made redundant. And this trade-off is at the centre of 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 large economic, social and political burdens through mutualising risks. There was a similar tug-of-war between sound incentives and increased burden-sharing in the debate on how the rescue mechanisms should be constructed, in the debate on the introduction of eurobonds as well as the debate on a true fiscal union, and it also shaped the debate on banking union.

Another case in point concerning the tug-of-war between sound incentives and burden-sharing is the debate on Germany's role in rebalancing the euro area. For sharing the burden of macroeconomic adjustment, commentators such as Martin Wolf and Paul Krugman have suggested that Germany should lower its competitiveness, say, by means of a considerable hike in wages; in other words, a larger increase than is warranted by conditions on the German labour market. The idea behind this is that competitiveness is relative: one country's loss is another country's gain. Unfortunately, according to our own estimates, the results of such a policy would be likely to disappoint. We assumed an additional wage increase in Germany of 2 percentage points above what would normally be expected as the outcome of bargaining. Then we used our economic models to calculate the effect that such an increase would have on the exports of peripheral euro-area countries. Owing to the nature of the trade flows between Germany and southern Europe, the effect would be close to non-existent. Only Ireland could expect a moderate lift. By contrast, Germany's economy would take a hit. Depending on the model, employment would ultimately fall as much as 1 %, and output by ¾ %. There would be no free lunch in terms of higher German purchasing power and higher exports of deficit countries. In the case of macroeconomic adjustment, burden-sharing through wage rises in Germany would be truly self-defeating. The same applies to a further fiscal stimulus in Germany.

In a globalised economy, any attempt to shield one European country from competition by lowering the competitiveness of another would be doomed to fail. A lasting resolution of the crisis will be achieved only by harnessing the forces of the market, not by doing away with them. This is true not only for the euro area, but also for the European Union as whole. This aspect of Prime Minister Cameron's much-discussed speech on Europe has received comparatively little attention, but I wish to second him on this point.

Harnessing the forces of the market for Europe as a whole means making the most of its main catalyst for competition and growth. Bringing the single market into line with the digital age and extending it to the entire range of services available within the European Union would harbour the potential for even surpassing the gains already achieved by the single market. In his report[1] to the European Commission, then Commissioner Mario Monti estimated the potential growth effects of creating a digital single market to be about 4 %, on a par with the gains made since 1993. Further benefits would ensue from a reduction in the vast number of exemptions in the single market for services. Even if it were not for the biggest economic crisis in post-war European history, it would be a shame not to tap into this reservoir. But under the current circumstances, it is even more imperative to make full use of the potential of the single market.

Reforms in this area could provide a much-needed boost to the monetary union as well. In other areas, progress is already visible. The process of macroeconomic rebalancing through structural reform is well under way. The current account deficits of Greece, Spain, Portugal and Italy are shrinking, and Ireland is already in surplus. Even more importantly, adjustment is being accomplished not only by shrinking imports, but also by growing exports. Obviously, taking the route of structural reform is a steep and challenging climb. But upwards is the direction we should aim for, and we should not deviate from that course.

3. Asserting the principle of liability in the monetary union

Harnessing the forces of the market through structural reform is the right strategy for regaining competitiveness at national level. By the same token, I am convinced that restoring market mechanisms where they have so far been impeded is crucial for strengthening the euro area's institutional framework as well. A constitutive element of any functioning market

[1] Monti, Mario (2010): A New Strategy for the Single Market.

economy is the principle of liability. Or, as Walther Eucken put it, "He who profits must also bear the losses."

When it comes to two of the biggest economic actors in the monetary union, this principle applies only to a limited extent. Banks and sovereigns being a priori deemed systemically important, since turbulence on either front threatens the stability of the financial system, would not bode well for the future stability of the monetary union. A framework in which two of the biggest players are at least partially exempt from the disciplining forces of the market would invite future aberrations and lack resilience. If we are to put monetary union on a sounder footing, such vulnerabilities need to be addressed as a matter of urgency. And, as both problems are so closely intertwined, any attempt to tackle one of them in isolation would be likely to fall short of what is required.

Let me first take a step back and look at why the close link between banks and sovereigns has proved to be so problematic in this crisis. If many banks get into trouble at the same time, possibly because of a large asset bubble bursting, financial stability as a whole is put at risk. 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 rewards excessive risk-taking and can place a huge strain on government finances – which is what happened in Ireland, where the need to support 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, and indirectly through worsening macroeconomic conditions.

Breaking the link between banks and sovereigns is important for making the euro area more stable. A banking union can be a big step in that direction – but again, we need to harness the disciplinary forces of the market, not do away with them. Core elements of a comprehensive banking union therefore have to be not just an effective single supervisory mechanism, but also a comprehensive bail-in of bank creditors, and a cap on exposure to individual sovereign as well as an adequate risk-weighting of sovereign bonds on banks' balance sheet – at least in the medium term.

Let me elaborate slightly on the second point. In order to minimise the risk to government finances posed by bank rescues, 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, with regard to the adequacy of capital buffers, sovereign bonds need to be adequately risk-weighted. Riskier bonds have to become more expensive in terms of the amount of equity they tie down, as is already the case for non-sovereign bonds. This serves two purposes. Firstly, such surcharges are designed to curb elevated demand and hence bring spreads more into line with the underlying risk, thus giving a disciplining signal to the respective sovereign. And, secondly, banks would become more resilient in cases of market turmoil. The former chief economist of the IMF, Professor Rogoff, even went so far as to state in an interview recently that adequate risk-weighting of sovereign bonds constitutes a far more effective debt brake than the mechanism envisaged in the fiscal compact. Furthermore, there should be caps on the maximum exposure of banks to individual sovereign creditors, as is already the case for private creditors. Such a step is especially important in terms of reducing the systemic importance of any individual sovereign, as Jörg Rocholl pointed out in a Handelsblatt[2] article two weeks ago.

A banking union will contribute to financial stability, but its design needs to preserve sound incentives for all the actors involved. This is true not only of future risks, but also of risks that have already materialised. After all, a banking union is also an insurance mechanism. And, as with any insurance, only loss and damage that is unknown ex ante should be covered. Therefore, "legacy assets" – in other words, those risks which evolved under the responsibility of national supervisors – have to be dealt with by the relevant member states.

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[2] Rocholl, Jörg: Risiko Staatspleite (Handelsblatt comment, 04.02.2013, page 48).

Anything else would amount to a fiscal transfer. It may be that such fiscal transfers are desirable or even deemed necessary. But then, they should be conducted through national budgets and be subject to the approval of national parliaments, rather than under the disguise of a banking union – which would then have to start out under a heavy burden – or, for that matter, through central banks. And, in the event of such transfers, the proper sequencing of events is crucial. We should not end up in a world where risks arising from bank balance sheets are rapidly mutualised, while an effective single supervisory mechanism is slow in coming.

Getting the single supervisory mechanism and a common resolution and restructuring regime operational is very important. Several conceptual questions need a convincing answer. How do we deal with the ten EU members that do not belong to the euro area? How do we ensure the effective separation of monetary policy and banking supervision? The devil is often in the detail.

I firmly believe that Europe has to get this project right and that it cannot afford to get off to a bumpy start. A banking union will not be a quick fix for the current crisis. But it is a major milestone on the road to a more stable and prosperous monetary union and hence instrumental in restoring confidence in the euro area. And this is the reason why I support it and why we need to get it right.

4. Conclusion

Ladies and gentlemen

The European debt crisis is heading into its fourth year, and there is still some risk that it will remain on everybody's mind for some time to come. But, especially with regard to the macroeconomic rebalancing of the euro area, many signs point to a silver lining. Restoring market mechanisms through structural reform is starting to pay dividends at national level, and this approach should also guide us when addressing the remaining weaknesses in the euro area's architecture. Asserting the principle of liability is key to breaking the negative feedback loop between banks and sovereigns. The task is daunting, often tedious and sometimes sobering. But I am convinced that it can be done and that the euro's best days are still ahead of us.

Thank you for your attention.