Andreas Dombret: How to overcome fragmentation in the European financial market

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 23rd European Banking Congress, Frankfurt am Main, 22 November 2013.

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1 Introduction

Ladies and gentlemen,

It is a pleasure for me to share some thoughts with you on the subsequent discussion of how to overcome fragmentation in the European financial markets.

When introducing a panel discussion, a sensible piece of advice is always to be briefer than anybody dared hope. I intend to follow this recommendation and will therefore limit my introductory remarks to no more than 15 minutes.

Allow me to talk about four aspects that we at the Bundesbank consider of particular importance when thinking about fragmentation within European Monetary Union. First of all, let me note that diagnosing financial fragmentation requires normative judgement. Moreover, fragmentation is, to some extent, natural. It reflects structural differences between national markets, which are not bad per se.

Second, let me share my thoughts on fragmentation and its implications in a monetary union. And third, we also need to look at supervision when talking about fragmentation and its roots. I will argue why the European banking union, in the Bundesbank's view, is an important step towards a more integrated European financial market. Finally, let me briefly touch upon the issue of fragmentation in the real economy.

2 Financial market fragmentation: A bad thing or to some degree natural?

Let me come to my first point: The reasons for fragmentation. The most obvious source of financial market fragmentation is the existence of different currencies. As we all know, in the euro area this source of fragmentation was eliminated by the introduction of the euro. But even before 1999 there were various political initiatives with the objective of overcoming market fragmentation in Europe. Most notably, let me mention the EU's internal market, which guarantees free movement of goods, capital, services, and employees.

Nevertheless, financial market fragmentation within the euro area has been discussed in quite some depth over the past few years. Probably most observers would agree that financial markets in today's European Monetary Union are still segmented or fragmented – especially when compared with the situation before the crisis.

But diagnosing financial fragmentation is by no means a purely technical exercise with a clear result. In the end, it requires a normative judgement, offering answers to questions such as: Which differences are well-founded and therefore justified? Which differences are not well-founded and, hence, potentially a sign of a dysfunctional market? Obviously, reasonable people can disagree substantially on the answers to these questions.

Strongly diverging prices of, for instance, government bonds may well be a sign of market fragmentation. However, determining the adequate risk premium as part of an interest rate is a highly difficult exercise. And central banks usually do not know better than market participants what the adequate risk premium or price should be. Coming from the private sector myself, let me add that central bankers should not even attempt to know better. And even if central bankers were to observe differences in prices or risk premia, this may be due to structural causes.

Allow me to make this point as clear as possible. Segmented markets are primarily the symptoms of underlying structural causes, which usually explain most of the differences. This applies, for example, to government bond markets, to the corporate credit market as well as to the interbank money market. Even if prices on these markets differ markedly among market participants or countries, it would be premature to interpret such differences as a definite sign of market exuberance or market malfunction, as a sign of irrationality or as a sign of inefficiencies.

Nevertheless, financial fragmentation can pose a challenge for the single monetary policy in the European Monetary Union (EMU), not least with respect to the monetary policy transmission channel.

3 How can the Eurosystem contribute to reducing fragmentation?

The single monetary policy cannot make a distinction between differing economic and financial conditions among EMU member countries. Instead, what matters for the single monetary policy is the aggregate situation of our monetary union. In this context, a well-known mechanism applies: The more similar economic conditions and economic policies of member states are, the more suitable the single monetary policy becomes for each member country.

Does this, in turn, mean that economic conditions as well as economic outcomes need to be the same in every single member state of a monetary union? No – in fact, on the contrary: If national economic policies and national public preferences are different from one country to another, national economic outcomes will differ as well. These differences will then be mirrored in different financial market conditions.

Therefore, even in a monetary union, different economic conditions are basically the rule and not necessarily an exception or a sign of a market dysfunction. Differing outcomes – not only in the financial sphere – are, in fact, compatible with a monetary union – as long as economies do not diverge too strongly and as long as important stability requirements are met.

So what is the role of the Eurosystem in the context of financial fragmentation? My central point is that the Eurosystem cannot overcome the structural causes of the market segmentation, because these causes are beyond its control. As the Eurosystem cannot solve the sovereign debt crisis, it cannot solve the ensuing market fragmentation, either.

I firmly belief that it is primarily the task of European governments to provide sound and lasting solutions to the various challenges posed by the sovereign debt crisis. Three things are particularly important in this context. First, in order to restore confidence, member states have to set both their public finances and their banking systems in order. Second, distressed member states have to implement the necessary structural reforms in order to become more competitive. And third, the present framework of our monetary union has to be strengthened and needs to be made more consistent.

The central banks in the euro area can, at best, cure the resulting fragmentation symptoms, but only to a certain degree. However, administering "central bank medicine" in order to treat fragmentation symptoms does not come without unintended consequences. It is more than important that such medicine does not prevent policymakers from tackling the underlying causes of the fragmentation.

Two very important structural reasons for fragmentation that became apparent during the crisis are the sovereign debt crisis and the nexus between the solvency of sovereigns and banks. This nexus is something we need to overcome. And here I see a prime role for the banking union to which I wish to turn now.

4 Banking union and the treatment of sovereign exposures

The European banking union will be a very important step – actually the most important European integration effort in the financial market since the introduction of our single currency. So far, financial markets in Europe are not the only entities which are to some extent fragmented along national borders – financial supervision is as well. This absence of a true level playing field has certainly contributed to financial market fragmentation. The application of uniform standards by a single European banking supervisor will foster integration. But single supervision has to be complemented with a single resolution mechanism. Only if a bank can be resolved in an orderly manner, without endangering financial stability, will authorities have the ability, and the courage, to declare such a bank non-viable. We still have too many banks in Europe lacking a viable business model but not exiting the market. A credible resolution framework can reduce supervisory forbearance as well as market turbulence and thus reduces the likelihood of a government bail-out. This will be essential in breaking the link between the balance sheets of banks and public finances.

But even a sound banking union will not be sufficient to reach our goal of making the financial system more stable. Apart from supervision and resolution, we have to look at bank regulation. The current regulatory framework, too, promotes this nexus between bank and sovereigns because it encourages banks to invest in sovereign debt. This reinforces the "doom loop" between the sovereign sector and the banking system. Should doubts about the sustainability of government debt arise, the national banking sector will also be negatively affected. This is particularly relevant in the European Monetary Union as European banks often only invest in the sovereign bonds of their home countries.

The current regulatory framework is biased towards sovereign debt in several ways. Generally, bank exposures to a single counterparty are limited to a quarter of a bank's eligible capital. But this does not apply to exposures to sovereigns, which are exempt from such rules. Furthermore, sovereign exposures are also privileged by low or zero capital requirements, as they are seen as more or less risk-free. Reassessing the regulatory treatment of financial institutions' sovereign exposures is crucial. More effective financial market regulation is necessary to ensure that a "doom loop" between sovereigns and banks cannot emerge.

But let me come back to fragmentation. We do not only observe natural differences and fragmentation in financial markets, but also in the real economy. And I would claim that we should not interpret this generally as a malfunction there either.

5 Fragmentation also exists in the Real Economy

Germany has been criticized for its relatively high current account surpluses. The current account balance in Germany is, however, not the result of distinct government policies or even central economic planning. It is, first and foremost, the result of market-driven processes reflecting the investment and saving decisions of millions of market participants. And they simply reflect structural causes. For countries like Germany, a current account surplus helps to absorb future burdens induced by its demographic development. In this sense, current account surpluses are not an economic harm but an economic asset.

Neither fellow European Monetary Union countries nor the European Monetary Union as a whole would be better off if Germany were to be weakened artificially. Especially, since the relatively strong balance sheets of German households, businesses, and of the public sector provide a certain degree of stability not only for Germany, but for the euro area as a whole. We have to accept the structural differences between economies.

This brings me back to the main points of my speech. First, that diagnosing fragmentation requires normative judgement. Second, fragmentation often reflects structural differences and is not bad per se. Third, that the banking union will be an important step towards more integrated financial markets. And last but not least, differences or fragmentation in the real economy may be justified as well.

Since a speaker should exhaust the topic, not the audience, I will close my introductory remarks here.

Thank you for your attention today, and I wish you a productive and rewarding discussion.