Andreas Dombret: Restoring financial stability

Address by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, on the occasion of the inauguration of the Bundesbank representative to Turkey, Istanbul, 26 November 2013.

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Dear Consul General Wolke,

Dear Deputy Governor Kenc,

Dear ladies and gentlemen.

Thank you very much for honouring us tonight with your presence.

Several centuries ago Isaac Newton observed: “We build too many walls and not enough bridges”. History has shown that there is a lot of truth in this sentence. And I am sure if Newton lived today he would be impressed by what has been achieved in Istanbul only recently. Complementing the existing bridges, the new Marmaray tunnel underneath the Bosporus Strait has just been opened. For the first time in history, a tunnel connects two continents.

Making connections is also what the Bundesbank has in mind in sending representatives abroad. With our network of representatives we aim to cover, in particular, the major G20 countries outside the euro area. Turkey is a prime example of a successful emerging market economy. This is also reflected in Turkey holding the G20 presidency in 2015.

Moreover, Istanbul is a financial centre of growing importance. Therefore, I am very happy indeed that we have now managed to close this gap in our network.

It is my pleasure to introduce Mr Hartmut Dräger, the Bundesbank’s first ever representative in Turkey. He will be available in the German Consulate here in Istanbul for your questions related to the Bundesbank and the European System of Central Banks. In turn, Mr Dräger will report back to us in Frankfurt on issues that help us to better understand economic and financial developments in Turkey.

Another important objective behind Mr Dräger’s secondment to Istanbul is our wish to further strengthen our relationship with the Central Bank of Turkey. For this reason I am grateful that my G20 colleague Deputy Governor Kenc was able to join us tonight.

Earlier this year, the Governors of our two central banks signed a Memorandum of Understanding. This Memorandum underlines their joint commitment to forge a deeper relationship between our respective central banks. Deputy Governor Kenc and I have agreed to give added substance to the Memorandum by holding a joint expert-level seminar on financial stability issues in the course of next year here in your great city of Istanbul.

Ladies and gentlemen, let me come back to the quote by Newton. Certainly, before European integration started, Europe was used to building walls. But walls separate. In Europe we have since gone some way to responding to Newton’s observation. The creation of the European common market without frontiers was the first significant step towards tearing down walls and building solid bridges across Europe.

Another milestone along the road to European integration was the introduction of the euro. Currently, we are working again on a historic project of European integration, namely the creation of a European banking union.

The banking union is currently our largest institutional construction site. The legal basis for the new European Single Supervisory Mechanism is now in place since 3 November, thus we have entered the implementation phase. The major challenge ahead is the comprehensive assessment of banks. Currently, the banking supervisors are selecting the critical balance sheet items of the banks under the Single Supervisory Mechanism. These items will then be subject to closer scrutiny. This appraisal of the present situation will be complemented by a joint stress test of the European Central Bank and the European Banking Authority which will be designed to reveal future risks.

It is essential to convince the markets that banks are solving their legacy problems before the European Central Bank takes over responsibility for banking supervision at the end of next year. The cleaning-up of the balance sheets will be an important pre-condition to ensuring a smooth start for the new supervisory regime.

In a market economy it is essential that banks, like any other business firms, can fail and can exit the market. “Too big to fail” was with us for much too long. Therefore, it is most important that we move from the old bail-out regime to the new bail-in regime in a credible way. Consequently, the Single Supervisory Mechanism has to be accompanied by a corresponding Recovery and Resolution Mechanism with a view to protecting taxpayers’ money from failing banks.

The rules specifying potential bail-ins have to spell out a clear pecking order for covering losses. Thereby, the principle of dual subsidiarity should be observed. To put it in a nutshell: Before public money is used, private creditors have to contribute to covering losses. And before European financial backstops, such as the ESM, are used, member states have to cover losses of their banks. This would reinforce another important principle, namely that liability and control have to go hand in hand.

This being said, let me emphasize that the Single Supervisory Mechanism, accompanied by a Recovery and Resolution Mechanism, can neither resolve today’s debt crisis nor act as a substitute for structural reforms and fiscal consolidation.

Apart from supervision and resolution, we have to look at bank regulation. The current regulatory framework promotes a nexus between bank and sovereigns because it encourages banks to invest in sovereign debt. This reinforces the “doom loop”, as Yves Mersch of the European Central Bank called it, 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 our monetary union as European banks often only invest in the sovereign bonds of their home countries. Therefore, in the medium term government debt should be backed with a level of capital which adequately reflects its risks. At the same time, caps should be imposed on bank sovereign debt holdings.

Ladies and gentlemen, in Newton’s terms the deepening of the European integration means that we are on our way to building more and more bridges. We are tearing down historic walls to allow for more cross-border activities and institutions to the common benefit of all European member states. However, this does not and cannot mean that individual member states can rely on the others to solve their problems.

Likewise, re-erecting old walls like the re-introduction of capital controls is not a sustainable solution. Such ad-hoc crisis measures might help in the short-term to preserve financial stability as in the case of Cyprus, yet they have to be combined with a clear perspective for phasing them out again.

I think Newton would not only recommend building new bridges. He would also be in favour of grounding these bridges on solid foundations. In economic policy terms this requires pursuing sound monetary, macroeconomic and structural policies.

And this applies for advanced as well as emerging market economies. All of this means that it was about time for the Bundesbank to send a representative to Istanbul. And we are very much looking forward to exploring joint projects with all of you.

Thank you very much for your attention.