Andreas Dombret: The euro area – routes to a stable monetary union

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Banken- und Unternehmensabend at the Bavarian Regional Office, Munich, 28 November 2013.

* * *

1. Introduction

Ladies and gentlemen

President Müller

It gives me great pleasure to speak to you this evening at the *Banken- und Unternehmensabend* at the Bavarian Regional Office here in Munich on the topic of “The euro area – routes to a stable monetary union”.

I’m sure we all agree on what the current action in the euro area is seeking to achieve: a stable monetary union. But have we taken the right route to make sure that we actually reach this destination? Everyone knows that all roads lead to Rome, but the routes to a stable monetary union are few and far between. I believe that we are on the right path – at least what we can see by the wayside gives cause for hope.

2. The national level – some early signs of success

Let’s take the problem of competitiveness. Significant imbalances have been evident in the euro-area countries’ current account balances in recent years. Countries like Germany or the Netherlands are consistently running surpluses, while others like Greece, Spain or Portugal have produced nothing but deficits. These imbalances have been symptomatic of the differences in competitiveness between the individual countries.

A topic which has made a comeback recently is the question of whether surplus countries should also contribute towards redressing these imbalances. But at the end of the day, structural problems in the deficit countries were what brought about these imbalances – so that is where the adjustments must take place. We must ensure that the other countries make their economies as competitive as Germany’s, is how ECB President Mario Draghi put it. Doing the exact opposite simply wouldn’t work.

And casting a glance at the crisis countries, we can see that many of them have already implemented necessary reforms, thereby boosting their competitiveness and narrowing their current account deficits. The European Commission’s latest estimates suggest that most crisis countries will run a current account surplus this year.

Even more important is the fact that this adjustment is being driven not just by shrinking imports but also by growing exports. All the crisis countries’ exports are likely to edge higher this year, with growth ranging from just under 1% in Portugal to roughly 4% in Spain.

The crisis countries haven’t made quite as much progress in tackling their government debt. They have undoubtedly made dramatic inroads into their annual fiscal deficits in recent years. But despite all their efforts, they will all still be above the Maastricht Treaty’s 3% deficit limit this year.

At the same time, their debt levels continue to grow. At the end of this year, Greece’s sovereign debt will be more than 170% of the country’s annual GDP. And things are not much better in other euro-area countries. At the end of 2013, government debt as a percentage of annual GDP will be 131% in Italy, 128% in Portugal and 133% in Ireland. So this is an area where we have some way to go.

But we should not observe the crisis solely from the perspective of structural problems in individual countries. So let's change our viewpoint and look at the crisis from a financial stability angle – it is a different perspective, but the structural problems of individual countries, above all sovereign debt, are naturally also an issue here.

3. A change of perspective – viewing the crisis from a financial stability angle

From a financial stability angle, the contagion channels were the key hallmark of the crisis. In the first phase of the financial crisis, beginning in 2008, banks infected each other – first, because they were financially mutually highly interconnected, second, because there was a general loss of confidence. The second phase of the crisis then saw banks infect the real economy, and the global financial crisis triggered a global recession. In Europe, banks ultimately infected sovereigns – and sovereigns infected banks. It was this sovereign-bank nexus which fuelled the crisis in the euro area.

Essentially, what we are talking about is a "doom loop". If government budgets run into difficulties, this weighs on banks – for example, if they hold government bonds on their balance sheets. Looking at the loop from the opposite direction, if a host of banks – or an individual large bank – experiences problems, then the government has no option but to come to the rescue if the worst comes to the worst. This puts pressure on the government budget.

This doom loop is a key problem for financial stability in the euro area. But how can we sever it? Generally speaking, it can be severed in either direction – anti-clockwise or clockwise, you could say.

Severing the anti-clockwise loop means giving banks better protection against distressed government budgets. Breaking through the clockwise loop, meanwhile, means making public finances more resilient to faltering banks. Let me take you on an imaginary journey, if I may, in both directions.

4. Anti-clockwise doom loop – sovereigns infect banks

If it is the anti-clockwise doom loop we are looking to tackle, there are essentially two ways in which we can shield banks against distressed government finances. First, we can make government budgets inherently more stable, thereby reducing the likelihood of them getting into trouble. Second, we can introduce regulatory requirements to ensure that banks are better protected in the rare event of a sovereign running into difficulties.

4.1 Preventing fiscal distress

Safeguarding the stability of government budgets is quite a challenge in the euro area on account of the specific structure of monetary union. What makes the European monetary union special is that it combines a single monetary policy with national fiscal policies.

The monetary policy for the 17 countries of the euro area is decided by the Governing Council of the ECB in Frankfurt. However, the fiscal policies of the 17 members of the euro area are decided by the national governments and parliaments – each country decides itself on its own government revenue and expenditure.

With such lopsided responsibilities, the individual countries have incentives to run up debt. At the end of the day, borrowing costs are distributed among all the member states of monetary union – either indirectly via higher interest rates for everyone or – as is now the case in the crisis – directly via the rescue packages. In the end, the community is jointly liable for the manner in which individual countries manage their budgets. Liability and control are out of step.

Basically, there are two ways to realign this imbalance: either the European level gains certain control rights over national budgets – which would mean deeper political integration.

Or we leave control of fiscal policy at the national level. But then the national level also has to assume liability for its policy – that would mean strengthening the existing framework of monetary union.

The first path would amount to what is known as a fiscal union. But that would depend on the countries of the euro area transferring national sovereignty to the European level – for example, by giving the European level the right to intervene in the case of unsound government budgets.

Such a waiver of sovereignty would be a radical change and require wide-ranging amendments to national and European legislation. But more than anything, such a change would need the support not only of policymakers but also of the general public. And, on this point, we should remain realistic. It is not possible to identify any will to do that at present – not in Germany or in any other country of the euro area.

This leaves us the second course of action: an improved Maastricht framework, a "Maastricht 2.0", as it were. Among other things, that means strengthening the rules on borrowing – the Stability and Growth Pact not only needs teeth, it also has to be able to bite. These rules have since been tightened – now they have to be applied and complied with.

A "Maastricht 2.0" would also mean taking the no bail-out principle more seriously again, however: no euro-area country should be liable for the debts of another. But that calls for the possibility of sovereign default as the ultimate logical conclusion of individual national responsibility. Sovereign defaults have to be possible without destabilising the financial system of the euro area as a whole. And this brings us to the question of how we can protect banks from situations like these.

4.2 Protecting banks against distressed public finances

Fiscal distress is particularly problematic for banks that hold government bonds on their balance sheets. And more than anything, it was banks in the programme countries and in Italy and Spain which bought up huge volumes of their domestic governments' sovereign debt – even during the crisis.

At the end of August, Italian banks' exposures to Italian general government amounted to 10% of their total assets. The equivalent figure for Spanish banks was 9%. What is more, it is chiefly weaker banks – poorly capitalised ones that are highly dependent on capital market funding – which bought up sovereign debt.

So if we are looking to offer banks greater protection against distressed public finances, it is government bonds we must target. From the perspective of prudential regulation, there are two factors which play a role here.

The first item regards banks' capital. Under the current regime, banks do not need to hold capital against the risks of loans to sovereigns – unlike other loans. The thinking here was that sovereign borrowers could not default and that loans to governments were therefore risk-free. And, if no losses could develop, it wasn't necessary to establish capital buffers. If it wasn't already necessary beforehand, the crisis has certainly forced a rethink.

Against that backdrop, it appears urgently necessary to change the rules. If banks were required to hold capital against the risks of their government bond portfolios, this would make them more resilient to fiscal distress. At the same time, banks would have an incentive not to buy such large volumes of government bonds.

And this takes us to the second issue: capital alone is insufficient. A crucial tool of risk management is diversification. The rule of thumb is "never put all your eggs into one basket". A cap on loans to an individual sovereign should therefore also be introduced.

Such caps have already been a fact of life for loans to the private sector for some time. They prevent banks from becoming overexposed to a single borrower. This makes them less

vulnerable to the default of that borrower – and this is something needed not just for private borrowers but also for government borrowers.

5. Clockwise doom loop – banks infect sovereigns

But we have to sever the doom loop in the other direction, too – clockwise. We have to protect government budgets from problems in the banking sector. The Irish case showed us just how urgently necessary this is: in 2010 Ireland, in order to save its banking sector, ran up debt amounting to 30% of GDP – the fact that this is largely taxpayer funds we are talking about here does not make the problem any smaller, of course.

Breaking the doom loop in that direction requires the same underlying strategy we have already applied. First, we have to make banks more stable so that distress is less likely. Secondly, we have to ensure that, if banks do run into trouble anyway, this does not put a burden on public budgets.

5.1 Preventing bank distress

If we bring up the subject of how banks can be made more stable, we open up a large field which reaches far beyond the boundaries of Europe. Reforming banking regulation is a global topic and is being conducted at the global level. The G20 leaders have developed a comprehensive reform agenda, a large portion of which has already been completed.

Discussing regulatory reform in detail would be beyond the scope of this speech. With respect to banks, its central pillars are: new capital rules and new liquidity rules. And, here, we have come a long way since the crisis. The new rules under Basel III require banks to hold more and higher-quality capital than ever before. At the same time, we have agreed on an international liquidity standard for the very first time ever. As soon as the new rules are finally in place, banks will be much more stable.

Yet rules are merely the foundation of a stable banking system. Someone also has to ensure that the rules are applied – that is a matter for banking supervisors. And, with regard to Europe, a further element enters the scene: the banking union.

In early October, the EU economic and finance ministers formally agreed to establish a Single Supervisory Mechanism (SSM) as the first pillar of the banking union. The SSM is scheduled to start its work in November 2014.

Joint supervision will make it possible to supervise banks everywhere according to the same high standards. That will prevent regulatory arbitrage. At the same time, it will prevent a situation in which a purely national supervisor unwittingly cuts domestic banks too much slack without any justification.

The banking union is unquestionably the largest European project since the introduction of the euro. We should therefore exercise particular prudence when implementing it. This includes initially conducting a careful and comprehensive review of the state of the European banking system. This inventory has already begun, and it will ensure that all legacy problems are disclosed prior to the introduction of the SSM. The time schedule for the banking union project is certainly ambitious, but I am confident we will be able to keep to it.

However, neither better rules nor a single supervisor can prevent individual banks from becoming distressed. And that is also a good thing: the possibility of failure is a cornerstone of a market economy. It must, therefore, be possible for banks to fail without rocking the entire financial system. Looking at our vicious circle, this leads us to the question of how we can protect sovereigns from banks' distress.

5.2 Protecting sovereigns from banks' distress

We are ultimately discussing a problem which already became relevant in the 2008 financial crisis: that of "too big to fail". Banks can become so large or so highly interconnected that

their failure can jeopardise the stability of the entire financial system. The collapse of Lehman Brothers showed us all what that can mean.

In order to prevent the financial system from collapsing, governments can be forced to rescue large banks in an emergency – also using taxpayer funds. That not only weighs on public budgets but gives banks distorted incentives. It encourages them to take greater risks. It is like the toss of a coin: heads, the bank wins; tails, the taxpayers lose.

Finding a solution to the "too big to fail" problem will be critical in order to protect public budgets from banks' distress. What we need is a resolution mechanism which will allow even large banks to be resolved without jeopardising the financial system or requiring the taxpayer to foot the bill.

Looking towards Europe, this is where the second element of the banking union comes into play: a single recovery and resolution mechanism for banks.

What will initially be decisive here is to define a clear liability cascade. Who is liable when banks founder? Shareholders and creditors undoubtedly should be at the very front of the line when it comes to shouldering losses. Taxpayers should be the last link in the chain, if they are even in the chain to begin with.

A Bank Recovery and Resolution Directive, which would cover all these factors and thus represent a great step forward, is currently being discussed at the European level. The draft version currently on the table, however, still leaves discretionary scope in deciding the extent to which creditors shall be held liable. In the interests of market discipline, that should be changed. It is also important that the resolution mechanism be introduced at the same time as the SSM, if at all possible.

On the whole, however, the banking union is a key milestone on the way to a stable monetary union, not least because it will help to sever the sovereign-bank doom loop – at least clockwise.

6. Conclusion

Ladies and gentlemen, we have examined the crisis from the perspective of financial stability. A key element is the doom loop of mutual contagion between banks and sovereigns, the vicious circle.

We will have to pull levers at several different places in order to sever this loop. We have to improve the framework of monetary union, especially with regard to the rules for sovereign debt. We have to adapt banking regulation. We have to elevate banking supervision to the European level. And we have to establish mechanisms which allow banks to be resolved without impacting on public budgets or taxpayers.

We should remain aware, though, that we will not be able to solve all problems through government regulation and government supervision. Financial stability starts first and foremost with banks themselves. It is the responsibility of banks to act as carefully and prudently as possible. And, in that respect, the banks squandered much in the way of confidence during the crisis.

Changes are needed here, ladies and gentlemen. We need a change of culture in the banking world. Banks have to return to the original role of the financial system: as a provider of services to enterprises in the real economy.

Together with the exigencies already mentioned above, this change of culture will enable us to reach our destination: a stable monetary union enabling prosperity and growth for all.

Thank you very much.