# Andreas Dombret: Current developments in Europe

Introductory remarks by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the German Embassy, Paris, 11 December 2013.

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Ladies and gentlemen

Let me kick off the discussion by offering some thoughts on the current state of play in Europe, and the euro area in particular. Many challenges have by now been overcome, yet some still remain ahead. Let me mention a few of them.

First, the markets are still concerned about the quality of banks' balance sheets and possible forbearance policies. The lack of transparency about true asset quality is certainly an issue. Price-to-book ratios of less than one testify to this.

Second, it is true that we have seen significant improvements in market access and funding costs during recent months. However, signs of fragmentation between the so-called periphery and other countries of the euro area are still evident. That is, financing conditions for sovereigns, banks and corporates continue to diverge along national borders.

Third, in many parts of Europe the necessary deleveraging process still has to continue. The corporate and private household sectors in some European economies are still riddled with debt from previous exuberance. Likewise, public deficits and sovereign debt levels are uncomfortably high in many countries.

Finally, growth, when measured on an annual basis, in the euro area remains subdued. The European Commission expects euro area real GDP to shrink by 0.4% in 2013. And in 2014, growth may well amount to a mere 1.1%. This adds to the challenges facing bank balance sheets and public finances.

So, is it all gloom and doom? Far from it, I would argue, as long as policy makers take the right steps. Let us take a short look at what has been done so far and what remains to be done.

Let me begin with the issue of monetary policy, as you would probably expect from a central banker. Only few would dispute that the measures taken by the Eurosystem have greatly reduced tail risks in the financial markets. However, I cannot conceal the concern that these measures come with diminishing rates of return. In fact, we may soon reach a point where their risks outweigh their benefits.

In the end, monetary policy cannot solve the crisis. Everyone agrees on this. All monetary policy can do is to buy time. And in doing so the Eurosystem has entered unchartered and dangerous territory.

Thus, policy makers should make good use of the time that monetary policy is buying. And indeed, Europe is proceeding with a comprehensive reform agenda to tackle the root causes of the remaining challenges.

One of these challenges is the close link between banks and sovereigns. Breaking this link is important for making the euro area more stable.

To achieve this objective, we have to adjust the regulatory treatment of sovereign exposures over the medium term. Two steps are important: first, an upper limit for banks' exposure to individual sovereigns should be introduced. Second, banks' investments in sovereign bonds should be backed with capital.

But there is more to do. A banking union can represent another major step to break the link between banks and sovereigns. Centralising supervisory powers over large banks can foster a comprehensive view and unbiased policy action that is not held hostage by national interests.

A first step in this direction will be the Balance Sheet Assessment under the auspices of the ECB. It is important to conduct this exercise in an impartial and unprejudiced manner. The German banking industry has already spent considerable efforts on cleaning its balance sheets – some as part of the Commission's state aid decisions, some in reaction to EBA stress tests, some for other reason. Thus, banks are in a better condition now than they were a few years ago. I am not afraid of huge surprises. But for all banks subject to the assessment it cannot be excluded that problems still remain. We need to uncover and address these problems now, before the single supervisory mechanism is launched.

Meanwhile, a comprehensive banking union has to comprise more than just an effective single supervisory mechanism. It needs to be complemented by a single resolution mechanism.

This is a necessary step to solve the too-big-to-fail-problem. Large banks must be able to fail without endangering the stability of the whole system. Otherwise, the government would have to step in to prevent a systemic crisis. This would create an asymmetry: Heads, banks win, tails, taxpayers lose.

Against this backdrop, establishing a clear hierarchy and minimizing discretion in the handling of bank creditor bail-ins is indispensable to win back lost trust. Based on the EU finance ministers' agreement of June 2013, the Recovery and Resolution Directive is now close to being adopted. It might ultimately turn out to be a net positive, as it provides clear orientation for markets. Moreover, it might even have positive effects for banks' financing conditions.

There is no doubt that the banking union is a major step forward in designing a better framework for monetary union. However, we also need structural reforms at the national level which are key to restore competitiveness and sound public finances. It is certainly true that reaping the fruit of success comes with a time lag. But experience from Germany – which ten years ago was nicknamed the "sick man" of Europe – shows that the benefits will come to the fore sooner or later.

And lately, growth data from the euro area have been indicating that a silver lining is appearing on the horizon, Macroeconomic rebalancing in the euro area is underway.

Importantly, the euro area left recession, with 0.1% growth in the third quarter. In, Italy and Greece contraction slowed down, while Spain joined Portugal and Ireland in leaving the recession behind.

At the same time, exports are increasing. All the crisis countries – except Cyprus – are projected to see some export growth this year, ranging from just 1/2% in Ireland to almost 6% in Portugal. These achievements are reflected in current accounts reverting more and more to positive balances.

Competitiveness has also improved in most peripheral countries. Since 2009 Greece has seen its unit labour costs diminish by over 8%, in Ireland, Spain and Portugal unit labour costs declined by 11%, 7% and 6% respectively. The structural reforms implemented are a key explanation for these successes.

Thus, at the center of the crisis, the situation is improving. But what about the two largest economies in the euro area; what about France and Germany?

Looking at France, we see good potential: the country is home to many renowned firms, it has a strong domestic market, and it has favourable demographics – in particular when compared to Germany.

However, it also faces structural challenges. The unemployment rate stands at more than 10% and France's world market share of exports has declined significantly over the past

10 years. And despite the consolidation efforts of the past years, public debt stands at more than 90% of GDP – a level that could become a significant burden on economic growth.

Additionally, France has acknowledged the importance of a competitive economy. The government has embarked on a number of reforms to increase the competitiveness of the economy. Furthermore, the social partners agreed on labour market reforms which could be an important step toward achieving a better functioning labour market.

Looking at Germany, the current situation seems to be quite pleasing: Germany's economy is in infinitely better shape than just ten years ago. Nevertheless, I do believe that we need a more level-headed assessment – Germany, too, faces structural challenges.

There are four important areas we have to address: First, Germany has to cope with unfavourable demographics, which will be increasingly felt in the coming years. Second, due to globalisation firms are going to face increasing pressure from emerging market competitors. Third, fiscal policy will have to bring down high public debt. And fourth, Germany is trying to completely change its energy policies. This change will have a profound impact on the competitiveness of industry and the purchasing power of households.

Thus, focusing on those countries in the center of the crisis might distract us from the fact that all countries in Europe face structural challenges – including France and Germany. At the end of the day, Europe can only work if all of us move in the same direction. Only together can France and Germany act as the driving forces of European integration. And only together can France and Germany help to solve the current crisis.

The positive developments I highlighted in my speech show the payoffs of staying on the path of reform. And they give us the necessary backing to do what most Europeans know needs to be done: use the window of opportunity of relative market calm. Use it to further push forward reforms, both, at the national and at the European level.

Thank you.