# Andreas Dombret: What is going on in Europe? The view from within

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the New York Stock Exchange, New York, 26 March 2014.

* * *

## 1. Introduction

Ladies and gentlemen

Thank you for inviting me to speak at the New York Stock Exchange. It is a great honour and pleasure to be here today.

In 1792, a few stock brokers gathered under a buttonwood tree at the lower end of Wall Street. In this meeting, they signed an agreement which, in effect, marked the birth of the New York Stock Exchange.

Today, more than 200 years later, the buttonwood tree is long gone; it fell during a storm in 1865. However, the New York Stock Exchange is still going strong and has become a guiding light in the financial and economic universe.

In this role, it has witnessed its fair share of ups and downs, booms and busts, tranquillity and turmoil. However, the last seven years have mostly been characterised by downs, busts and turmoil. Since 2007, we have lived through a succession of crises: a global financial crisis, a worldwide recession, a sovereign debt crisis in the euro area and, most recently, turbulence in some emerging markets.

These episodes have once again underscored how closely interconnected the global economy has become. What drives growth and prosperity in good times can easily turn the other way in a crisis. In a globalised world, a problem at one side of the globe can quickly spread to the other side. To paraphrase Winston Churchill: "a financial crisis gets halfway around the world before policymakers have a chance to get their pants on".

In a globalised world, what happens in the United States is relevant to Europe and what happens in Europe is relevant to the United States. Against this backdrop, I wish to shed some light on the situation in the euro area and offer you an inside view.

## 2. There is light at the end of the tunnel

For nearly four years now, the state of the euro area has been defined by the sovereign debt crisis. However, I have good news for you – there is light at the end of the tunnel.

Most importantly, the euro area as a whole has finally left recession. By now, we have seen three consecutive quarters of positive growth, and looking ahead, the outlook for this year and next year is also quite encouraging. Projections by the ECB suggest that euro-area GDP will grow by just over 1% in 2014 and by 1½% in 2015.

And this recovery is not only driven by the "core euro-area" countries such as Germany. Some of the crisis-hit countries have also finally embarked on the path to recovery. And those which have not can at least see the light at the end of the tunnel.

It seems that the efforts to implement structural reforms are gradually bearing fruit. Competitiveness has improved in most peripheral countries over the past few years. Almost everywhere, unit labour costs have fallen substantially. Improving competitiveness in turn drives exports higher. All peripheral countries – except Cyprus – are projected to see some export growth this year. These achievements are reflected in current accounts increasingly reverting to positive balances.

And Germany is part of this rebalancing equation. Since 2007, Germany's current account surplus vis-à-vis the euro area has shrunk continuously from 4½% of GDP to 2% of GDP. As business investment in Germany is projected to pick up in 2014 and 2015, this rebalancing should continue.

The progress that these abstract figures reflect is also visible in more concrete events. For example, Ireland and Spain have exited their financial support programmes without any friction. And Portugal is planning to leave its adjustment programme in the first half of this year. All three countries recently returned to the sovereign bond markets at relatively low yields.

It seems that international investors are increasingly acknowledging the countries' efforts and achievements. In the case of Ireland and Portugal, international investors have bought more than 80% of the newly issued bonds. At the same time, stock markets in these economies have been rising for some time now. These developments underscore the progress that some peripheral euro-area countries have made in adjusting their economies.

However, due to different starting points some countries are naturally more advanced in their adjustment process than others. Especially in Greece further efforts are necessary to manage the turnaround.

## 3. The role of monetary policy

Now, what is the role of monetary policy in this process? Monetary policy certainly helped to prevent the crisis from escalating. Still, there is one thing we should be clear about: monetary policy cannot solve the underlying causes of the crisis.

Nevertheless, some observers propose an even more expansionary monetary policy. They are worried about the risk of deflation in the euro area. It is certainly true that current inflation rates are rather low but, in my view, the risk of deflation is limited. And on this issue, the Bundesbank and the ECB agree.

The argument rests on three pillars:

- First, around two-thirds of the drop in inflation is due to falling prices for energy and food. These are exogenous factors and their effects are likely to be temporary.
- Second, low inflation rates in the euro area are partly the result of necessary adjustments in the crisis-hit countries. These should also be one-off effects.
- Third, there are no signs of a self-enforcing downward spiral of prices and wages. Long-term inflation expectations are firmly anchored at a level that is in line with the ECB's definition of price stability. Private households do not seem to be postponing expenditure in expectation of a further drop in prices. There are no indications of a substantial increase in the savings rate.

Fears of a fate similar to that of Japan are therefore misplaced. Moreover, the notion of Japan's "lost decades" needs to be seen in perspective. The weak growth in Japan is partly a natural consequence of the country's changing demographics, as the working-age population there has been shrinking since the mid-1990s. That, incidentally, is an economic policy challenge that awaits some euro area economies in the years to come – most notably Germany.

## 4. There are still some obstacles to overcome

So, even after taking into account the issue of deflation, we can still see the light at the end of the tunnel. However, we have not reached it yet. There may still be some obstacles that could block the way – some of them we can already see, others we cannot see.

The latter are what Frank Knight, one of the founders of the Chicago school of economics, called "unknown unknowns". A recent example is the political crisis in Ukraine. However, while this is an example of an "unknown unknown", it has only limited potential to prevent us from reaching the end of the tunnel. Ukraine contributes only a quarter of a percent to global economic output. Furthermore, the exposure of European banks to Ukraine is relatively small. According to data from the Bank for International Settlements it stands at about US$23 billion.

A known obstacle that could block our way, on the other hand, is the prolonged period of very low interest rates. But please do not misunderstand me: the current status of monetary policy is certainly adequate. Nevertheless, when interest rates stay very low for a very long time, we may experience unwanted side-effects.

One of these side-effects is the search for yield. Investors may eventually increase the risk of their investments to make up for the shortfall in yields caused by low interest rates. And, indeed, it seems that investors already began their search for yield. In corporate debt markets, for instance, valuations are already somewhat stretched. And in the global low-interest rate environment, ambitious valuations may well spread to other market segments.

In this regard, the strong recovery in the property markets of some euro-area countries should set us thinking. Take the German housing market, for example. Between 2009 and 2012, prices in large cities rose by almost 25%. And, in 2013, they increased by another 8.9%. Calculations by the Bundesbank already point to overvaluations in urban areas.

Nevertheless, when looking at the German market as a whole, the situation seems less dramatic. In 2013, prices rose by an average of 4.5% – a figure that does not give too much cause for concern. Overall, prices in Germany have not yet moved away from fundamentals.

For me, warning bells would start ringing if there was a rapid increase in housing prices accompanied by a significant rise in lending. And even more warning bells would be ringing if this rise in credit was accompanied by deteriorating lending standards. Having said that, I can assure you that at this point in time I am surrounded by silence.

But it is not only bond markets and housing markets we have to look at. Since we are at the NYSE, let us take a look at stock markets. In 2013, there was only one way for most stock markets to go and that was up. The EuroStoxx 50 increased by 18%, the FTSE 100 by 14%, the Dow Jones by 28%, and the Nikkei skyrocketed by as much as 57%. Market volatility decreased, too. After years of risk aversion, sentiment switched to a "risk on" mode.

Did financial markets enter a new phase of "irrational exuberance"? Such a verdict is certainly debatable. But financial markets are at least anticipating significant further improvements in economic fundamentals and prospects. And they are anticipating that governments around the world will continue to implement the necessary reforms. These expectations create vast scope for confidence shocks.

This, in turn, interacts in an unfavourable way with another risk arising from a prolonged period of low interest rates. A prolonged period of low interest rates could set the wrong incentives. It could encourage banks to postpone necessary balance sheet adjustments. And it might induce governments to postpone necessary structural reforms and the consolidation of public finances.

In my view, this could be the biggest threat to the recovery process. The improved outlook together with low interest rates could lead to complacency and reform fatigue. We cannot let this happen. We cannot let it happen because there is still a lot to do to put the euro area back on a solid footing. Reform at the national level must continue and, looking to the future, reform at the European level is equally important.

## 5. How do we get to the end of the tunnel?

At the European level, the most important project is the banking union. The banking union is most certainly the biggest step since the introduction of the euro. And it is the most logical step to take. A single currency requires integrated financial markets and this includes the supervision of banks.

Consequently, one of the pillars the banking union rests upon is a Single Supervisory Mechanism – that is European bank supervision for the largest banks. Centralising supervisory powers in such a way can foster a comprehensive and unbiased view upon banks. It also enables policy action that is not held hostage by national interests. Thus, it will contribute to more effective supervision and better cross-border cooperation and coordination.

However, the banking union does not rest on one pillar alone. A second pillar is necessary to keep everything in balance. This second pillar is the Single Resolution Mechanism. European bank supervision requires European bank resolution – otherwise there would be an imbalance between liability and control.

In a wider sense, resolution mechanisms are essential 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: If everything goes well, the bank wins. If everything goes downhill, the taxpayers lose. This creates moral hazard for banks, endangers financial stability and threatens public finances.

The Single Resolution Mechanism will solve this problem. It will allow authorities to restructure or resolve banks without putting taxpayers' money at risk. In the future, whenever a bank fails, resolution costs will have to be borne first by shareholders and creditors. After that, a bank-financed resolution fund will come into play, and only as a last resort are public funds to be used and the taxpayer made to pay.

And there is even more to do before the banking union starts. One of the biggest preparatory steps is undoubtedly the Comprehensive Assessment of those banks which will fall under European supervision. This Comprehensive Assessment consists of two elements: a backward-looking Asset Quality Review and a forward-looking stress test.

The objective of the Asset Quality Review is to uncover legacy assets in banks' balance sheets that were accumulated while the banks were under national supervision. The objective of the stress test is to assess how resilient banks are to stress scenarios.

Any capital shortfalls revealed by the Comprehensive Assessment have to be rectified before the banking union starts. Ideally, this would primarily involve private funds. If private funds should not be available and the bank has a sustainable business model, the respective government could step in. Ultimately, it is a question of who is responsible for past failings in banking supervision – and that is the individual member states.

The Comprehensive Assessment will allow the banking union to start with a clean slate. At the same time, it will support the necessary deleveraging of European banks. Balance sheets will eventually be "cleaned up" and any doubts regarding their quality will be removed. This will improve banks' capacity to lend to the real economy and thus support economic growth. Against this backdrop, it is crucial that the Comprehensive Assessment is conducted in a tough and thorough manner.

In this context, let me briefly compare the European stress test with the corresponding stress tests for the United States. One question might be: which of the two is stricter? Well, comparing the strictness of these two stress tests is not that simple. In the United States, a threshold of 5 per cent of capital relative to a bank's risk weighted assets is stipulated, in Europe, it is 5.5 per cent. Does this mean the European stress test is stricter? In my mind, such a comparison is inadequate.

A meaningful comparison should not only include the threshold for the capital, but also the macro scenario. However, the macro scenarios for the European stress test have yet to be finalised; they are due to be published at the end of April. But even if we knew the scenarios, a comparison would still be difficult: The scenarios do not take into account just one variable, such as GDP growth, but – in the case of the US stress test – 28 variables. What's more, the horizon of both stress tests is not one year, but more or less three years. A large number of variables therefore have to be compared over a three-year horizon.

In all likelihood, any comparison between the two stress tests would therefore be ambiguous. Sound stress testing methods are essential to correctly determine banks' capital needs, and I am certain that the European stress test will fulfil this requirement.

## 6. Conclusion

Ladies and gentlemen, I have covered a lot of ground in my speech today. Nonetheless, the central message is straightforward. The situation in the euro area is improving and there is light at the end of the tunnel. However, there is no time for complacency. Risks remain, among them reform fatigue and the side-effects of low interest rates. Thus, we must continue our efforts to put the euro area back on a sound footing.

Two weeks ago, ECB president Mario Draghi said that 2012 and 2013 were years of stabilisation for the euro area and that 2014 and 2015 may be years of recovery. If we continue down the path of reform, his expectation will prove correct.

But as I said at the beginning, the world has become closely interconnected and so, too, have risks and problems. The prolonged period of low interest rates is as much a global problem as it is a European one.

And one thing is certain: interest rates will rise again at some point. However, managing this turnaround will prove a formidable challenge that requires careful policy design and adequate communication. The recent turbulence in emerging markets in response to the Fed's tapering decision was a case in point.

It was a case in point which needs some qualification. In the end, it was domestic problems and a lack of progress in reforms that made some emerging markets vulnerable. To restore investors' confidence, they should address domestic vulnerabilities by strengthening macroeconomic policies and reinvigorating structural reform efforts.

Although the turbulence in emerging markets does not have the potential to derail the global recovery it shows how sensitive markets are at the moment. There is still considerable scope for negative confidence shocks.

Therefore, the ball is now in the court of policy-makers – in the euro area, in the United States and in emerging economies. If they press ahead with the necessary reforms, we will eventually be able to leave the times of downs, busts and turmoil behind us.

Thank you very much.