Andreas Dombret: Crisis management in the euro area and challenges ahead

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Danish Economic Association, Copenhagen, 8 May 2014.

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1. Introduction

Ladies and gentlemen

Thank you for inviting me to speak at the Danish Economic Association today, and many thanks to Governor Per Callesen from Nationalbanken for making this possible. It is a pleasure to be here.

You should know that the Nationalbanken and the Bundesbank have been working closely together for many years now and that we share many views. So let me take the opportunity to thank Per and his colleagues for many years of fruitful exchange.

I would also like to use this occasion to say how impressed I am with the Danish – or rather Nordic – model of combining economic flexibility with social security. In my view, this model strikes a balance which could serve as a blueprint for other European countries as well.

Thus, from a structural point of view, Denmark seems to be closer to the vision held by John Maynard Keynes. He said: "The day is not far off when the economic problem will take the back seat where it belongs, and the arena of the heart and the head will be occupied or reoccupied, by our real problems – the problems of life and of human relations, of creation and behaviour and religion."

And Denmark has a number of great thinkers who busied themselves with what Keynes calls the "real problems". One of these thinkers is Soeren Kierkegaard. And he said: "Life can only be understood backwards but it must be lived forwards".

Of course, today I am not going to philosophise about life because, unfortunately, Europe still faces some economic problems. Nevertheless, I will apply Kierkegaard's principle to the subject of today's speech: the European sovereign debt crisis.

When endeavouring to understand the origins of the crisis, we have no choice but to look backwards. Yet, our policies need to be forward looking. Thus, I will talk about both how the crisis emerged and the challenges that lie ahead.

There is, however, one part of the picture that I will have to leave out: the current economic situation in Europe. Why is that? Well, on Thursday the Governing Council of the ECB will meet to take interest rate decisions. A gentlemen's agreement among European central bankers compels us not to discuss any issues related to monetary policy in the week prior to those meetings and I will of course honour this agreement.

Thus, all I can say with regard to the current situation is that the end of the crisis is coming closer – slowly but surely. This is also the message of the EU Commission's Spring 2014 Forecast that was published on Monday. Referring to the forecast, Commission Vice-President Siim Kallas stated that "recovery has now taken hold".

But looking back, the question is: how did we get into that problem in the first place? To answer this question, let us take a look back to 25th March 2010.

2. Looking back: the causes of the sovereign debt crisis

On that day, Jean-Claude Juncker, then President of the Eurogroup, made a statement on Greece. This statement included the following words: "As part of a package involving substantial International Monetary Fund financing and a majority of European financing, euro-area member states are ready to contribute to coordinated bilateral loans."

That sounds somewhat long-winded. Put simply, it means that the euro-area heads of state and government were ready to support Greece financially. That statement could be seen as the official start of the sovereign debt crisis in the euro area, the "starting shot" so to speak.

It wasn't of course the real start. The crisis was not something that happened suddenly, but rather the end of a long road. And the road leading out of the crisis is just as long. It is just as long, but much more arduous, particularly for those countries which are directly affected by the crisis.

And everyone agrees on where the road should lead: a stable monetary union. What is controversial, however, is what road we have to take in order to arrive at that destination.

And this seems natural as there are a very large number of angles from which it is possible to look at such a complex phenomenon as the sovereign debt crisis. And depending on the angle, it is possible to tell somewhat a different story. The core elements of those stories are always the same, however. We can find them at both the national and the European levels.

Let us first take a look at the national level; in other words, the countries themselves. Following the introduction of the euro, a large amount of capital flowed into the countries which are now at the centre of the crisis such as Greece, Ireland, Portugal, Spain and Cyprus. First of all, that is economically plausible: capital flows from highly developed countries into countries that are catching up economically.

In our case, however, the inflowing capital did not finance a sound catching-up process. Instead, it financed house price bubbles in some countries – such as Ireland and Spain. Elsewhere, it funded excessive government consumption – for example, in Greece.

The inflowing capital did not fund sound growth: instead, it masked an existing lack of competitiveness and, in fact, made it even worse. And it was precisely these structural problems that were the breeding ground for the crisis.

What was the situation at the European level? Here, it was mainly shortcomings in the framework of monetary union that laid the ground for the crisis.

In order to understand these shortcomings, it is important to know the particular features of monetary union. The European monetary union is special because it combines a single monetary policy with national fiscal policies.

The monetary policy for the 18 countries of the euro area is decided by the Governing Council of the ECB in Frankfurt. However, the fiscal policies of the 18 members of the euro area is a matter for the national policymakers – each country decides itself on its own government revenues and expenditures.

Given such an imbalance of responsibilities, the individual countries have incentives to borrow. This incentive to borrow, this "deficit bias", was also recognised by the founders of the monetary union. In order to reduce it, they did two things.

First, they created explicit rules on borrowing in the form of the Stability and Growth Pact. This Pact was intended to keep a tight check on national fiscal policies.

Second, they incorporated the "no bail-out" principle into the Maastricht Treaty: no euro-area country was to be liable for the debts of another member state.

Thus, individual responsibility was to be the guiding principle for fiscal policy in the monetary union. Each country was itself to bear the consequences of its own fiscal policy.

These rules were intended to keep borrowing by the euro-area countries within reasonable limits. But rules were not the only means of achieving this. The financial market actors, too, were to ensure that that the euro-area countries did not incur excessive debt.

The idea behind this is simple: if a country were to become excessively indebted, it would only be able to borrow on the financial markets in future at very high rates of interest. This means that the country in question would have to reduce its debt to a sustainable level.

Yet, neither of these two safeguards worked. Neither the discipline of the financial markets nor the rules were able to prevent individual countries running up excessive debt.

Investors on the financial markets tolerated the problems of individual countries for far too long. At the same time, policymakers stretched and sometimes ignored the rules of the Stability and Growth Pact.

And then, in 2008, came the global financial crisis. Many countries had to rescue their banking systems and support economic activity. And that dramatically drove up their levels of sovereign debt.

And, suddenly, the investors on the financial markets seemed to become aware of the problems which some countries were experiencing. Now they saw the high level of sovereign debt, the lack of competitiveness and the risk of contagion effects between the individual countries. In short: they lost confidence in the crisis-hit countries. But this also meant that capital flows dried up – the capital flows that had previously covered up the problems.

In order to safeguard financial stability in the monetary union as a whole, rescue packages were set up; first for Greece, then for Ireland, Portugal, for the Spanish banking system and, finally, for Cyprus.

At the same time, central banks took various non-standard measures to stabilise the situation.

In an exceptional crisis, taking exceptional measures is undoubtedly the right thing to do. However, looking to the future, neither course can provide a permanent solution to the crisis. Neither the rescue packages nor monetary policy can remedy the basic underlying problems that I have just mentioned.

3. Looking forward: ways out of the sovereign debt crisis

In order to achieve that, I believe three things to be necessary. First, government finances have to be put back in order; second, competitiveness has to be improved; third, the framework of monetary union has to be strengthened. Let us look at these three necessities in more detail.

3.1 Budget consolidation and structural reforms

Many euro-area countries have very high levels of sovereign debt. Take Greece as an example: even though the country is projected to have a primary surplus this year, total debt keeps growing and stands at 175% of annual economic output. Compared to Denmark's 44.5%, this is a dizzying number.

And in other member states, too, sovereign debt is well above annual economic output. Against that backdrop, reducing government debt has to be an urgent necessity.

The associated course of fiscal consolidation has come in for some criticism, however. It is argued that, especially in a crisis, too many austerity measures place an unnecessary drag on the economy. However, a distinction has to be made at this point: in the long term, sound government finances are good for the economy – no-one disputes that. In the same way, no-one disputes that austerity measures can dampen economic activity in the short term.

But we should look beyond the present moment and, above all, not confuse cause and effect. What triggered the crisis was the very fact that governments were no longer able to borrow on the markets because they had already accumulated excessive levels of debt. Saving is essential in order to regain the confidence of the markets. That is the only way to eliminate the financing problems.

On one point, the critics are right, however: saving is not enough on its own, it is only part of the necessary structural reforms.

And that brings us to the second thing that is needed. Not only do the countries have to put their government finances in order, they have to reform their national economies so that they become competitive again. And there is no short-cut to achieve this objective. Monetary policy in particular is not an alternative to structural reforms – this is not only true with regard to the peripheral countries but also with regard to the large countries of the euro area including Germany and France.

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 with regard to the crisis countries, the benefits are already visible.

To sum up: At the national level we see some progress that can be explained by the structural reforms implemented. This progress is not least visible in 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 just ten days from today. All three countries recently returned to the sovereign bond markets at relatively low yields.

Now let us turn to the European level.

3.2 A better architecture for the monetary union

If we want a stable monetary union, it will not be enough to eliminate the problems at the national level alone. We also have to improve the architecture of the monetary union.

I cited the central weakness at the start of my speech: the imbalance between a monetary policy conducted at the European level and fiscal policies conducted at the national level.

Basically, there are two ways to realign this imbalance: either the European level gains certain control rights over national budgets. That would mean a 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 policies – that would mean strengthening the Maastricht framework.

The first course 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 public finances.

Giving up sovereignty in this way would be a radical change and require wide-ranging legislative changes nationally and at the European level. More than anything, such changes would need the support not only of policymakers but also of the general public. And, on this point, we should be realistic. It is not possible to identify any willingness to do that at present – not in Germany or in any other country of the euro area.

This just leaves the second course of action: that is, an improved Maastricht framework, a "Maastricht 2.0". 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. The 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. But that calls for the possibility of sovereign default as the ultimate logical conclusion of individual responsibility. Sovereign defaults have to be possible without destabilising the financial system of the euro area as a whole.

3.3 The banking union as part of a better architecture

And that is an important point, because the close link between government finances and the financial system was a major element of the crisis.

Basically, this is very much a vicious circle: if public finances run into difficulties, the banks are put under strain– if the banks hold government bonds on their balance sheets, for example.

Conversely, if banks run into difficulties, public finances are put under strain. Take the example of Ireland: in order to save its banking sector, Ireland ran up a budget deficit amounting to 30% of its economic output in 2010.

There are various approaches to breaking through this vicious circle. One of them is the planned European banking union.

One pillar of the banking union is joint banking supervision for large banks, the Single Supervisory Mechanism. The ECB is planning to launch the Single Supervisory Mechanism on 4 November. As you can imagine, this is a formidable challenge. It is a project that is comparable to the creation of monetary union but scheduled to be rolled out at seven times the speed.

Centralising supervisory powers at the European level will foster a comprehensive and unbiased view upon banks. It will also enable 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.

Against this backdrop, non-euro area countries might also benefit from joining the Single Supervisory Mechanism. For countries such as Denmark the door is open to join and personally, I would be very happy should Denmark, at some point, decide to join the Single Supervisory Mechanism.

But all of that cannot entirely rule out the possibility of bank failure. And that is a good thing. After all, the risk of corporate failure is a core element of the market economy.

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

In this regard, the EU has made crucial progress recently, with the adoption of a harmonised bank resolution regime and the decision to create a Single Resolution Mechanism.

The Single Resolution Mechanism 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.

The Bundesbank welcomes and supports this as an important complement to common European supervision. Most importantly, the banking union has to start with a clean slate. Thus, one of the biggest preparatory steps is 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, which also applies to four Danish banks.

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.

4. Conclusion

Ladies and gentlemen

With regard to the sovereign debt crisis it seems that Soeren Kierkegaard's advice did not fall on deaf ears.

Policy makers throughout Europe looked back and understood the causes of the crisis. Looking forward, they drew the right conclusions and initiated the necessary reforms – at the national and at the European level.

Against this backdrop, the greatest obstacle we face is certainly reform fatigue. This is something we must not allow to happen. Completing the reforms is the only way for us in the euro area to achieve our objectives of a stable monetary union and a stable euro.

This would not only benefit the euro area itself but each and every country in Europe. I am confident that we are on a good path.

Thank you very much for your attention.