Andreas Dombret: Designing a stable monetary union – progress and open issues

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Brookings Institution, Washington DC, 8 October.

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1. Introduction

Ladies and gentlemen

Thank you for having me here today. It is a privilege to speak at an institution as distinguished as Brookings. For almost a century now, this institute has provided essential analytical input for the work of policymakers around the world. Naturally, this includes central banks such as the Bundesbank.

And it is at the Bundesbank that my speech begins. Allow me to bring up my very first week in office – a week I still remember vividly. Naturally, it was a decisive week for me, but even more important, it was a decisive week for the euro area. My first day of work was on 3 May 2010.

On the day before, on 2 May 2010, the EU finance ministers had agreed to support stumbling Greece with a €110 billion rescue package. One week later, on 10 May 2010, the ECB decided to buy government bonds in order to stabilise the financial markets – a decision which the Bundesbank has criticised.

Looking back, no one can deny that this first week of May 2010 was a turbulent one. To many, it even counts as the "official" start of the euro crisis. To me, it was a time when two things became obvious.

First, many observers from outside Europe – notably from the US – underestimated the political will in Europe to hold the euro area together. Second, many observers from inside Europe – including myself – overestimated the stability of the euro area's institutional framework.

What is the logical conclusion of these two insights? The conclusion is that we have to take advantage of the apparent political will in order to improve the euro area's institutional framework. But how?

In my view, the overarching theme in this regard is integration. To be sure, Europe's political landscape now features a number of parties that are riding a wave of euro-scepticism and anti-European rhetoric. This is a disturbing development. Nevertheless, political leaders and the majority of people throughout Europe are still very much convinced of the idea of a unified Europe.

And from an economic point of view, deeper integration could help to strengthen the framework of the European monetary union. Let us take a look at three areas where further integration could be the way forward.

2. Fiscal union – beyond the horizon

The first area is public finances. And in order to understand the core of my argument, it is important to be familiar with the particular features of the European monetary union. The European monetary union is special in that 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 euro-area member states are a matter for the national policymakers – each country decides on its own government revenues and expenditures.

This imbalance of responsibilities gives individual countries an incentive to borrow – a "deficit bias" is built into the system. Our objective should be to counter that deficit bias to ensure a stable monetary union. This can only be achieved by realigning responsibilities – liability and control have to be in balance.

And one way to rebalance liability and control is deeper integration. If we were to take this path, the European level would gain certain control rights over national budgets. This would amount to what is known as a fiscal union. However, such a step 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 event 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 need to be realistic. I cannot identify any willingness to do that at present – not in Germany or in any other country of the euro area.

This means that, for the foreseeable future, control of fiscal policy in Europe will remain at the national level. Thus, in this area, deeper integration still lies beyond the horizon.

But if the current state of lopsided integration prevails, the national level must assume liability for its policies. That would mean strengthening the current set of rules on borrowing: the Stability and Growth Pact. These rules have since been tightened – now they have to be applied and complied with.

This framework is supplemented by a permanent crisis resolution mechanism: the European Stability Mechanism, or ESM in short, which was established in 2012. The objective of the ESM is to be able to counter severe risks to financial stability in the euro area. The effectiveness of the ESM is based on the idea of a strong deterrent: as long as markets believe the ESM to be powerful enough to act in a crisis, they have much less incentive to speculate against any euro-area country. This principle is now being called into question by an idea that the President of the European Commission, Jean-Claude Juncker, has recently floated. He suggests using free ESM funds to finance investments in infrastructure. In my view, such a step would greatly reduce the effectiveness of the ESM.

In a way, the discussion about liability and control relates to monetary policy. The Governing Council of the ECB recently decided to buy asset-backed securities. This decision represents a far-reaching change in the ECB's monetary policy: the objective is not just to boost lending, but also to directly pump money into the economy.

The effect of this measure would be to transfer credit risks taken by private banks to the central bank and, ultimately, to the taxpayer. Were this to take place even despite the lack of an adequate compensation for the risks, we would have another specific policy measure that increases the imbalance between liability and control: bank owners would not be responsible for their credit decisions, leaving taxpayers to once again foot the bill. This contradicts nearly all the G20 initiatives that are currently underway.

3. Banking union – tomorrow's reality

Ladies and gentlemen, at this point in time, a fiscal union remains more of a vision than of a concrete step to be taken anytime soon. However, in another area, Europe is about to take a significant step towards deeper integration.

Less than a month from today, the ECB will assume direct supervision of the 120 largest banks in the euro area – thereby erecting the first pillar of a European banking union. The 120 banks which will come under the supervision of the ECB account for more than 80% of the aggregated balance sheet for the euro-area banking sector. Thus, the ECB will become one of the world's largest supervisors.

The banking union is certainly the biggest step towards financial integration in Europe since the launch of our common currency. And to me, it is the most logical step to take. Single monetary policy requires integrated financial markets – which includes, without doubt, European-level banking supervision.

European banking supervision will allow banks throughout the euro area to be supervised according to the same high standards. In addition, cross-border effects can be covered better through joint supervision than by national supervisors. And adding a European perspective to the national view will put more distance between the supervisory authority and the entities it supervises. This will minimise the danger of supervisors getting all too close to their banks and thus treating them with "kid gloves" out of national interest.

Meanwhile, a comprehensive banking union has to comprise more than just an effective European banking supervision. The second pillar of the banking union is a European resolution mechanism to deal with future bank failures. This mechanism will be in place from 2016 onwards. If push comes to shove and a bank is no longer viable, shareholders and creditors will be first in line to bear banks' losses, and taxpayers' money will only be the very last resort. Thus, the European resolution mechanism will also contribute to disentangling the close connection between banks and public finances, which was a central problem in the euro crisis.

However, one thing should be clear: regulation will not solve all of our problems. The banks themselves have to adapt to the challenges they face. One of these challenges is profitability. Given the costs of stricter regulation and the prevailing low-interest-rate environment, remaining profitable poses a challenge to many euro-area banks. Thus, it is essential that banks recognise their weaknesses and do something about them early on.

Looking at German banks, this could be achieved by boosting income in fee and commission business and by looking into cost-cutting measures. There is traditionally a strong branch network in Germany. Streamlining it could reduce costs. Mergers might also make sense for some credit institutions, with the focus in each case being on the sustainability of each business model.

4. Capital markets union – the day after tomorrow?

In any case, the banking union is definitely a major step forward in designing a better framework for the European monetary union. However, we should broaden our view beyond the banking sector. A deeper integration of capital markets would also contribute to sharing opportunities and risks.

To be sure, we have come a long way in integrating capital markets in Europe. According to statistics provided by the Bank for International Settlement, European banks' claims within Europe stood at 36% of GDP at the end of the 1990s. By 2008 the share had grown to 77%. This share has fallen during the crisis, but still stands at around 48% of GDP.

However, there are two caveats regarding this trend of capital markets integration in Europe. First, the financing structure of European companies is still predominantly bank-based. A look at the balance sheets of German companies, for instance, shows that bank credit still accounts for about 15% of the liability side. This is certainly lower than the 22% observed at the end of the 1990s, but compared to the US or the UK there is still room to increase the share of capital market financing.

Second, although banks' cross-border exposures have increased, capital market integration remains incomplete. In the banking sector, for instance integration has concentrated on the interbank market while credit markets for companies remain predominantly national. The integration of the markets for capital may have increased in Europe, but the ownership structures of many companies have not. They are still strongly national.

The relatively low level of integration in European capital markets represents a barrier for risk sharing. Equity holdings in the US, for instance, are much more widely dispersed throughout the entire country. Thus, when a negative shock hits an industry or a specific region, the resulting losses are spread widely beyond that region. In Europe they are not, because equity holdings are much more concentrated nationally.

Empirical studies for the United States show that integrated markets for capital cushion around 40% of the cyclical fluctuations between the US federal states. A share of around 25% is smoothed via the credit markets, while fiscal mechanisms cushion just 20% of shocks. Studies for Canada and Sweden come to similar conclusions.

Against this backdrop, two general lines of action could be followed in Europe. First, it might be beneficial to increase the share of capital markets in the financing structure of companies. This would, of course, require a shift away from the traditional bank-based system to a certain degree. In this context, it might be worth taking a closer look at tax regimes, among other things. Currently, tax treatment still favours debt financing over equity financing. Removing this bias in taxation would encourage companies to strengthen their equity base and thus turn more towards capital markets in their search for sources of funds.

On a side note: strengthening the equity base is also a central issue with regard to banks, as the crisis has shown. Nevertheless, strengthening the equity base of banks is less a question of providing the right incentives, but rather a question of outright regulatory requirements. And here, we have already come a long way.

The second line of action would be to deepen the integration of capital markets, which might eventually result in the formation of a capital markets union. To be sure, the concept of a capital markets union is not as clear-cut as that of a banking union. Capital markets are complex and non-bank finance takes many forms: corporate bonds, private equity, public equity, venture capital or peer-to-peer lending, to name just a few. And integration not just relates to financial products but also to integral elements of the respective markets, such as stock exchanges and central counterparties. Thus, any attempt to form a capital markets union would require a lot of different measures in a lot of different areas.

Nevertheless, the idea of a capital markets union has gained some traction lately. Among others, the President of the European Commission, Jean-Claude Juncker, and Yves Mersch, Member of the Executive Board of the ECB, have promoted the concept of a capital markets union. To me, it would be a logical step to supplement the banking union with a capital markets union. It would reduce fragmentation in European financial markets and, at the same time, enhance their efficiency and stability. Thus, it is certainly a goal worth pursuing.

5. Conclusion

Ladies and gentlemen

George Washington is credited with having written, more than two centuries ago in a letter to a friend, that a United States of Europe would come into being. This is certainly a bold vision which has been voiced repeatedly since the days of George Washington – by Winston Churchill and, more recently, the former Vice-President of the European Commission, Viviane Reding.

The vision of a United States of Europe is a very broad approach aiming at an encompassing political integration. In my speech today, I have taken a more modest approach and argued from an economic point of view. I have highlighted three areas where deeper integration might help to enhance the stability of monetary union.

The first area is public finances, although a fiscal union is currently a rather unrealistic vision. The second area is the banking system, and here we are on the eve of a major step towards integration – in November of this year, the banking union will become reality. The third area is capital markets. Looking to the future, I consider a capital markets union another project that would contribute to enhancing the stability of monetary union.

In my view, integration is the way forward as long as it is balanced. Not all proposals for deeper integration that are currently being discussed fulfil this criterion. Take the example of eurobonds: in essence, eurobonds would provide a joint guarantee for individual sovereign debt. This step would increase the imbalance of integration I mentioned when I discussed the issue of a fiscal union. Thus, what we need are balanced steps of integration such as those I have described in my speech.

To be sure, these are all big steps, but in my view they are worth taking. A stable monetary union will eventually benefit all member states, including Germany. This is a deep belief I hold, a belief that has even grown since my first week at the Bundesbank.

Thank you.