# Andreas Dombret: Looking to the future – what comes next in terms of European financial integration?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the South African Institute for International Affairs, Johannesburg, 10 April 2015.

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## 1. Introduction

Ladies and gentlemen

Thank you for inviting me to speak at the South African Institute for International Affairs. I appreciate the Institute's objective of conducting evidence-based policy research as part of an international dialogue. It is therefore a great pleasure to be here today to take part in and to promote such an international exchange of ideas.

A dialogue is essential in the age of globalisation, in which countries are no longer isolated but part of a closely interconnected community. And this community consists of a growing number of countries. Over the past decades, we have seen the emerging economies steadily being integrated into the global economy. And looking to the future, I firmly believe that the role played by emerging economies will become greater still. Your country is a prime example: South Africa plays a leading role in Sub-Saharan Africa and is also a respected member of the G20, reflecting its role in the world economy.

A globalised economy offers huge potential to all its members. Nevertheless, while we all share the benefits in good times, we also have to share the burdens in bad times. The global financial crisis has highlighted how closely the world has grown together and how quickly a problem in one corner of the world can spread around the globe.

This truth applies all the more to countries sharing a common currency such as the member states of the Common Monetary Area here in southern Africa or the euro area in Europe.

Let us take a closer look at the euro area and the challenges it is currently facing. Back in 1999, 11 European countries adopted the euro as their common currency. Today, the single currency is shared by 19 countries and more than 300 million people, which in my eyes makes it a success story. That being said, it has not always been plain sailing.

In the wake of the global financial crisis of 2008, the euro area slid into a financial crisis of its own. This was compounded in 2010 when Greece entered into a sovereign debt crisis, leading to other member states suffering a sudden loss in confidence, which eventually brought the euro area to the brink of collapse. Extensive rescue packages by the governments along with non-standard measures taken by the European Central Bank helped to calm the markets and prevented the crisis from escalating.

To some commentators, the current situation might look similar. Greece's newly elected government objected to complying with the financial assistance agreements and intended to withdraw some of the reforms that had already been adopted. There were even brief calls for further debt relief. However, after intense negotiations among the finance ministers of the euro area, the Greek government settled for requesting an extension of the current programme. After the Greek government had also committed to pushing ahead with economic and fiscal reforms, the finance ministers of the euro area approved a four-month extension of the programme. The details of a new financial assistance programme need to be worked out by summer.

Greece certainly needs further assistance from the rest of the euro area. However, further assistance can only be granted if Greece continues with its efforts to restore sound public finances and competitive economic structures.

Some observers see these developments as an indication that financial integration in Europe has failed. I see these developments as an indication that financial integration in Europe has to go further. Let us take a look at three areas where further integration could be the way forward for Europe.

## 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 19 countries of the euro area is decided by the Governing Council of the ECB in Frankfurt. However, the fiscal policies of the 19 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. This is because the negative consequences of borrowing are spread across all the member states of monetary union – for example, by means of a higher interest rate level for all of them. 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 fiscal 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.

Giving up sovereignty in this way would be a radical change and require wide-ranging changes to national and European legislation. 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. In this area, deeper integration still lies beyond the horizon.

## 3. Banking union – the reality of today

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 has just taken a significant step towards deeper integration.

On 4 November 2014, the European Central Bank assumed direct supervision of the largest banks in the euro area – thereby erecting the first pillar of a European banking union. As of today, this concerns 123 banks which together account for more than 80% of the aggregated balance sheet for the euro-area banking sector. The European Central Bank has therefore 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 the euro in 1999. 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 allows 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 puts more distance between the supervisory authority and the entities it supervises. This minimises the danger of supervisors getting all too close to their banks and 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. This will realign incentives and make the entire banking system more stable.

## 4. Capital markets union – the day after tomorrow?

The European banking union is definitely a major step forward in designing a better framework for the European monetary union. However, Europe should broaden its view beyond the banking sector. Consequently, the EU-Commission has proposed to establish a European capital markets union. Following monetary union and the banking union, this will be the third major step of financial integration in Europe.

In essence, the European capital markets union has two objectives. The first objective is to increase the share of capital markets in the funding mix of the real economy. The second objective is to integrate capital markets more closely across borders.

Some people relate the first objective to the question of whether a capital markets-based financial system is superior to a bank-based financial system. Well, to sum up the empirical evidence: it depends. It depends on a number of factors and country-specific characteristics, which makes it hard to provide a general answer.

Nevertheless, the recent crisis shed light on these issues from another angle. A system in which the real economy relies on a single source of funding will most certainly run into trouble when that source dries up – regardless of whether it is bank funding or capital market funding.

Therefore, it is not a question of "either/or". The objective of the European capital markets union is not to abandon bank-based funding but to supplement it with capital markets-based funding. And in Europe above all places there is ample room to do so. The European stock market is only 60% the size of the US stock market when measured in relation to GDP. Likewise, the European market for venture capital is 20% the size of the US market, and for securitisations the percentage is even lower.

In the end, it comes down to the uncontested argument of diversification. Increasing the share of capital markets will improve and broaden access to funding particularly for small and medium-sized enterprises which form the backbone of many European economies. At the same time, it will improve the matching of investors to financial risk, thereby increasing the efficiency of the financial system. As a result, the financial system will be able to better support sustainable economic growth.

The second objective of the European capital markets union is to improve the integration of capital markets in the entire European Union. One of the main arguments is that integrated capital markets can improve private risk sharing. The technical question is: to what degree does a shock to the economy affect consumption?

Empirical studies for the United States show that integrated capital markets cushion around 40% of the cyclical fluctuations among the US federal states. A share of around 25% is smoothed via the credit markets, while fiscal policy cushions 10–20% of shocks. Altogether, around 80% of a given economic shock is absorbed before it can affect consumption. Studies for Canada yield similar results.

In Europe, the picture looks different. Here, it is mainly credit markets that cushion economic shocks – and they are not very effective in doing so. Altogether, only around 40% of a given shock is absorbed before it can affect consumption. Increasing the share of capital markets and integrating them across borders would therefore help improve risk sharing in Europe and reduce the volatility of consumption.

To be sure, the argument for a capital markets union is straightforward, but implementation will be much less so. The capital markets union is a complex undertaking affecting many different areas. Consequently, the European Commission has presented a wide range of suggestions and steps to be taken. Nevertheless, I firmly believe that Europe should embark on the path towards a capital markets union in order to enhance the stability and prosperity of its economy.

## 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 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 European fiscal union is currently a rather unrealistic vision. The second area is the banking system, and here we have taken a major step towards integration – in November 2014, the banking union became a 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 the European economy.

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 and also the rest of the world.

Thank you.