Carl-Ludwig Thiele: The euro − past pitfalls and future challenges

Speech by Mr Carl-Ludwig Thiele, Member of the Executive Board of the Deutsche Bundesbank, at the People's Bank of China School of Finance, Tsinghua University, Beijing, 22 September 2015.

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1. Introduction

Dear Professor Li,

Dear Professor Kang,

Ladies and gentlemen,

I am delighted to have the opportunity to be here in Beijing to talk to you about Europe and the euro – about the background and particular features of European monetary union, its pitfalls, which have placed Europe under great strain, and the challenges that we need to overcome if Europe is to remain a reliable player.

European monetary union has its peculiarities, which makes it difficult to compare it with any other single currency area. It is only when one is aware of these particular features and the historical backdrop against which this currency area has emerged that it is possible to understand the causes of the crisis in the euro area – and the steps needed to overcome them.

In my presentation, I will attempt to view European unification, a stable European monetary union and a prosperous euro area through the eyes of a realist. However, Walter Hallstein, the first President of the European Commission, apparently had a special kind of realist in mind when he said: "Whoever does not believe in miracles in European matters is not a realist."

I will come back to this at the end of my speech.

2. European unification

Ladies and gentlemen,

A united Europe is of major significance to Germany. This is not only because Germany is an integral part of Europe but also because the Germans feel a particular obligation to promote European unification. The reasons for this are largely historical.

A glance back in history shows just how important mutual understanding and amicable relations are for the countries of Europe.

The First World War broke out just over 100 years ago. This war has been etched into the memory of so many Europeans. The grim consequences of war are still fresh in our minds: a disturbingly high number of civilian and military victims, the wartime economy, hundreds of thousands impoverished or starved to death and survivors deeply traumatised. This list could go on and on.

And the Second World War began only 21 years after the end of the First World War. It was a war in which unprecedented crimes were perpetrated, millions were left dead and Europe was subsequently divided into two blocs.

After suffering so much at the hands of war, the west European countries strived for deeper European integration, for a united Europe.

The reasons for this were many and varied. Securing peace within Europe was undoubtedly the dominant rationale.

The relationship between European neighbours France and Germany played a key role in this context. Hostility between the two nations, be it overt or latent, had persisted for centuries. This so-called "Franco-German enmity" was surmounted in the wake of the devastating Second World War and developed over time into a Franco-German friendship, an engine driving the process of European unification and integration.

However, belonging to a community of values was of particular importance to Germany following the Hitler dictatorship and the Holocaust.

Konrad Adenauer, the first Chancellor of the Federal Republic of Germany, expressed this as follows: "The unity of Europe was the dream of a few. It became the hope of many. Today it has become a necessity for all of us."

But there was also a desire to sustainably improve Europe's economic prosperity.

It is not incidental that European integration began by stepping up economic integration.

After the Second World War ended, progress was made on various fronts, culminating initially in the single European market.

The foundations of this single European market were the "four basic freedoms": the free movement of people, goods, services and capital.

But it became evident at an early stage that economic integration in Europe could only really take off if it was accompanied by a stable single currency.

As far back as the start of the 1970s, there existed a plan to establish a European economic and monetary union that was to be fully implemented by 1980.

Ultimately, progress was not so rapid after all. No serious attempt to establish monetary union was made until Jacques Delors took over the presidency of the European Commission in the late 1980s.

The Maastricht Treaty was later signed by EU member states in 1992.

3. European monetary union and its regulatory framework

In 1999, the long-cherished dream of European monetary union became true, marking a major step towards deeper European integration.

Introducing a single currency had tangible benefits.

- Prices of goods could be more easily compared throughout the member states.
- Exchange rate risk was eliminated and transaction costs fell.
- This in turn promoted trade, not only within the monetary union but also with the rest of the world.
- Money and capital markets converged further.
- And, last but not least, the euro brought with it a period of remarkable price stability for the member states.

At this point, it is important to understand that the European monetary union is a thoroughly unique single currency area. While the 19 sovereign states within it have committed to comply with a single monetary policy, they remain responsible for their own fiscal and economic policies.

This means that a single monetary policy, which has the clear objective of ensuring price stability, is accompanied by 19 national fiscal policies.

As you can see, the principle of subsidiarity is constitutive for Europe: as many decisions as possible should continue to be made at the national, or even the local, level.

Former United States Secretary of State Henry Kissinger once highlighted the EU's complex structure by asking: "Who do I call if I want to call Europe?"

Nowadays, he would have to call 19 telephone numbers to discuss fiscal policy matters, as 19 national governments make decisions regarding public spending and any borrowing required for financing purposes.

The universal rule that political processes can easily lead to increased spending and, as a result, to excessive borrowing as well applies far more to a monetary union with independent national fiscal policies than to central governments.

This is because, in a monetary union, the negative effects of a sharp rise in debt in one country can spill over, at least in part, to the other member states.

Why is that the case?

Generally speaking, the same rules that apply to a private borrower also apply to a country: the higher the debt burden, the lower the creditworthiness.

So, in a properly functioning capital market, a country that is more indebted is generally required to pay higher interest on its sovereign debt.

However, things are different in a monetary union, as capital market participants assume that the member states belong to an "inseparable union with a common destiny" as part of which they will help each other out financially in emergency situations, forming a kind of joint-liability scheme.

As a result, debt interest rises not only for the individual, more indebted country, but usually also for the other member states, which are expected to provide solidarity and financial assistance.

Yet, for the country creating more debt, interest rates tend to rise less strongly.

Monetary union, therefore, holds incentives for an individual member state to run up higher debt as the negative effects of greater indebtedness – meaning higher borrowing rates – are partly borne by the other member states.

This can be compared with the overfishing of the seas as it, too, affects both the community of neighbouring countries as well as the country causing the problem.

The architects of monetary union were well aware of the problem of incentives. Which is exactly why they took precautions.

It was, therefore, laid down from the start in the Treaty of Maastricht that a country is forbidden from assuming the debt of another country or the community of states. In other words, this laid down the foundation for a general no bail-out principle.

The Maastricht Treaty is, thus, guided by the principle of individual responsibility, or the balance of liability and control.

In the concise words of German economist Walter Eucken: "Whoever reaps the benefits must also bear the liability."

Or, in very down-to-earth terms: Whoever orders, pays.

An additional security threshold for monetary union as a stability union is the prohibition of monetary financing of governments. The central banks of the Eurosystem, that is the European Central Bank and the 19 national central banks, are forbidden from directly financing euro-area countries.

In order for this ban on monetary financing of governments to be implemented in practice, the independence of the Eurosystem from political instructions was enshrined at the same time.

Political decision-makers cannot, therefore, force the central banks of the Eurosystem to grant member states loans or directly purchase their sovereign paper. Ultimately, these measures could contravene the mandate of ensuring price stability, causing lasting harm to the Eurosystem's credibility and thus to the very foundations of a successful monetary policy.

Germany has, in the past, had bad experiences with central banks which were not free of political lobbying. For example, expenditure on arms in the First World War was financed directly by the central bank, which essentially catered to the needs of the government. The consequence was a complete devaluation of the Reichsmark.

By contrast, the independence of the Eurosystem was firmly anchored.

First, institutionally, by prohibiting national and supranational institutions from issuing the ECB or the national central banks with instructions.

And second, functionally, by awarding the sole prerogative regarding strategies and measures to ensure price stability to the Eurosystem.

The independence of the central banks is further safeguarded by specific debt ceilings, which are intended to prevent member states from accumulating excessive debt.

> A country's public deficit is not supposed to exceed a maximum of 3% of its GDP within a one-year period.
>
> Moreover, a country's overall sovereign debt should not go beyond 60% of its annual GDP.

These rules are designed to prevent governments from exerting pressure on monetary policy makers, as lower interest rates allow governments to borrow more cheaply. Or due to the fact that existing debt is devalued by a higher rate of inflation. So far so good.

4. Crisis

However, things turned out differently than expected – above all because the carefully drafted financial policy rules were not complied with.

Most countries were far from having a balanced budget, and public deficits often even exceeded the three-percent threshold.

Debt levels in the member states were often not lowered either. The exact opposite was the case in some countries for that matter.

At the same time, market participants did not trust sufficiently in the no bail-out principle I touched on earlier.

Despite the very large differences in debt levels and economic developments among the euro-area member states, they aligned their risk premiums to a great extent, which, in turn, led to the already strongly indebted countries becoming more indebted.

In the end, confidence in the capital markets vanished with regard to whether the future crisis countries would still be able to service their sovereign debt in accordance with the rules. This culminated in investors granting these countries loans only at very high interest margins or withholding them altogether.

At the same time, it became clear that the countries that were later hit by crisis had failed to set up sound and sustainable economic structures that were beneficial for growth.

Instead, enterprises and households often took advantage of the substantially lower interest rates as a result of joining the euro area and ran up great amounts of debt.

And rather than investing this money in expanding competitiveness, it was used for private and government consumption.

Wages increased to a considerably larger extent than productivity, with price competitiveness eroding as a result.

And last but not least, cheap loans and capital inflows fuelled the real estate bubbles in Ireland and Spain.

This is why this “special boom”, which was caused by low interest rates, was anything but sustainable and sparked the crisis in Europe. Although, to be precise, “the crisis” was a conglomerate of various crises, encompassing financial market crisis, economic crisis and sovereign debt crisis.

Above all, however, it is a crisis of confidence, the complexity of which is also reflected in the fact that the euro area has been battling to overcome this crisis for seven years now.

5. Overcoming the crisis

How can this finally be achieved? Or, put differently, what lessons are to be learned from the crisis?

To win back the confidence lost and to return to a path of sustainable growth, we need to tackle the root causes of the crisis instead of treating the symptoms.

The economic situation in the euro area may be recovering, but there are still some structural challenges to resolve. And until the causes of the crisis have been eliminated, we cannot be sure that it will not pop up again. The most recent discussions on Greece have shown this only too well.

5.1 Measures in the member states

First of all, the crisis countries themselves must eliminate the causes of the crisis at home.

For one thing, they have to ensure that their public debt is sustainable. This needs to be done before consumer and investor confidence can return.

Indeed, as the saying goes, “you can’t borrow your way out of a debt crisis”.

Therefore, lasting confidence can only be built on a foundation of sound public finances.

In addition to having budgetary rigour, member states also need to implement growth-enhancing structural reforms.

Many of these have already been set in motion as a result of the sovereign debt crisis. As such, not only have structural budget deficits been significantly lowered, but the deterioration of international competitiveness has also been largely reversed.

But there is still some way to go in terms of making the labour markets more flexible, further liberalising the goods and services markets and cutting bureaucracy.

To begin with, these adjustment processes are a burden on the economic recovery of many of the crisis countries. However, the subsequent positive growth effects more than make up for this.

Spain, in particular, is currently experiencing this first-hand and is already reaping the benefits of the structural reforms it has implemented. Since 2009, its structural budget balance has improved by roughly seven percentage points and its labour market has been made more flexible. Both of these achievements were decisive factors in enabling the Spanish economy to lift itself out of recession quite some time ago and to exhibit its current strong growth. The oppressively high levels of unemployment are also gradually decreasing. The benefits for Spain will be all the higher in the coming years if it remains fully faithful to this reform process.

There is a saying I like that practically passes as a Chinese proverb in Germany. It reads: “When the winds of change are blowing ... some people build walls and some people build windmills.” Well, the Spanish have built quite a few windmills in recent years.

In the first half of this year, the world’s attention was focused on Greece to a much greater extent than on Spain and its successful reform process. In light of the refusal of the Greek government to accept the bail-out conditions, and due to acute financing needs, there was even speculation about whether the country would potentially have to leave the euro area or even the European Union itself.

This risk has since vanished, thanks to the adoption in August of a third assistance programme for Greece, which is subject to strict conditions and temporarily resolved the country’s funding bottleneck. However, further payments are contingent on Greece fulfilling these conditions.

In addition, the central challenge facing Greece lies in implementing structural reform measures for greater competitiveness as well as achieving sound government finances in the long term and establishing a functioning administration.

Only then will Greece overcome its current period of weakness and embark on a path of growth.

5.2 Reforming the regulatory framework

However, aside from the unsound developments in European periphery countries, the euro area’s regulatory framework also needs to be strengthened. The principle of aligning liability and control must once again be more rigorously enforced.

This is because, over the course of combating the crisis, the element of joint liability has been increasingly expanded. This, in turn, has severely disrupted the balance between liability and control.

> The crisis countries were granted large-scale emergency loans by other member states and the European Stabilisation Mechanism.
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> But the Eurosystem also reacted, for example by not only lowering interest rates, but also by loosening the requirements for monetary policy collateral.
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> In addition, the Eurosystem acquired government bonds of crisis countries on the capital markets in order to ensure monetary policy had a more uniform impact. However, this propelled the Eurosystem deep into uncharted and dangerous territory, blurring the boundary to prohibited monetary financing of governments.

That being said, all parties are well aware that monetary policy is unable to resolve the crisis in the euro area, and is merely buying time for policy makers to implement the necessary measures.

In order to permanently safeguard monetary union as a union for stability, it is important to bring liability and control back into a more balanced position.

Essentially, this can be done in two ways:

> either the euro area evolves into a genuine fiscal union, where fiscal and tax policies are coordinated centrally at European level ...
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> ... or a Maastricht Framework 2.0 is established in which the principle of individual responsibility is reinforced.

However, I do not see a majority in any euro-area country supporting the communitisation of fiscal and tax policies. At the current juncture, reinforcing the existing regulatory framework and strengthening the principle of individual responsibility therefore seems like a more realistic way of bringing liability and control in Europe’s monetary system back into equilibrium.

Europe has already taken some steps in the right direction in this regard.

For example, the refined fiscal rules require balanced budgets or even slight surpluses.

In addition, procedures have been introduced to identify and rectify macroeconomic imbalances.

However, these rules need to be enforced.

And this is where we have a clear deficit. "Flexibility" is the European Commission's new watchword when it comes to interpreting how the fiscal framework should be implemented. And the scope for flexible interpretation has actually widened over the past few years on the back of changes to the budgetary rules.

However, sustained economic growth cannot be built on a foundation of resurgent expanding public debt. For as I already mentioned, lasting confidence and long-term growth are only possible through sound public finances.

Ladies and gentlemen,

Thus far I have touched on two key areas where there are lessons to be learned from the crisis:

first, that individual countries need to implement reforms themselves and

second, the need to strengthen and strictly adhere to a regulatory framework in which liability and control at the national level are balanced – as envisaged for the euro area from the start.

5.3 European banking union

Moreover, as the crisis unfolded, the financial system was exposed as the Achilles' heel, not just in Europe but on an international scale.

As a result, steps were taken at the G20 level to tighten banks' capital and liquidity requirements, thus giving rise to Basel III.

Compounding this, weaknesses were identified in Europe's banking supervision structures. National supervisors were often found to assess their own country's banking system too favourably, with the effect that failing banks and stumbling states dragged one another down.

Only by destroying the harmful nexus between banks and governments will we be able to manage these contagion effects.

And this is where the nascent European banking union comes into play. It represents a major step towards deepening European integration and consists of two elements:

The Single Supervisory Mechanism (SSM), which operates under the aegis of the ECB, has been in place for just under 12 months. Its purpose is to ensure consistently high supervisory standards so as to prevent banks, at an early stage, from getting into difficulties.

But such problems cannot be entirely ruled out, not even under a stringent regulatory regime. After all, the possibility of failure is a hallmark of any market economy.

It is therefore important to be able to allow banks to fail without governments – and thus also taxpayers – having to foot the bill. For banks must also be subject to the liability principle, without which no market economy can function properly.

This is the rationale behind the launch of the European Single Resolution Mechanism (SRM) in 2016. The mechanism will make sure that non-viable institutions can be withdrawn from the market in an orderly fashion provided this does not jeopardise financial stability. And this will be done according to a clearly defined liability cascade.

If a bank is wound down in future, shareholders and creditors will be first in line to bear the costs.

Only when this source of funds proves insufficient will there be recourse to a single resolution fund financed by the entire European banking sector.

And only as a last resort will taxpayers in the respective country, or even in other member states, be called upon to help shoulder the burden.

In other words, beginning in 2016, institutions subject to supervision at the European level will also be resolved at this level. This will facilitate closer European integration.

Together, these two constructs, the SSM on the one hand and the SRM on the other, form a meaningful whole, in which liability and control are balanced.

5.4 Abolishing the preferential treatment of government bonds

If the close ties between governments and banks are to be loosened, in future loans to sovereigns must no longer be deemed free of risk in regulatory terms.

It follows that government bonds should henceforth be treated similarly to loans to enterprises and households, meaning they should be backed by capital commensurate with the risk. And limits also need to be applied to such exposures, as is the case with loans to private debtors. This would prevent risk from becoming concentrated on banks' balance sheets.

These topics are now being deliberated by the Basel Committee on Banking Supervision and the European Economic and Financial Committee, and rightly so. I appreciate that capital requirements and large exposure limits make the task of financing governments more complicated and consequently more expensive. Thus, gradual phase-ins are undeniably a good idea. However, this is no reason to refrain from change.

5.5 Sovereign insolvency code

Looking ahead, there is an additional area where new regulatory provisions are required. In extreme cases, sovereigns, too, must in future be able to declare themselves insolvent, as the liability principle should also apply to them. Otherwise, the Eurosystem could come under pressure to finance cash-strapped governments at knock-down terms.

So what happens when a sovereign defaults? It doesn't mean that the country concerned disappears off the map in the way that a company might.

Rather, the government in question finds itself no longer able to service its debt as contractually agreed, normally meaning that this debt has to be restructured.

The legal basis for this would have to be provided by a sovereign insolvency code. In my opinion, this is an essential prerequisite for an enduringly sustainable regulatory framework in which fiscal policy remains a national responsibility.

6. Conclusion

Ladies and gentlemen,

In my presentation, I have shone a light on the history of European integration and the crisis in the euro area. I have also looked towards the future, and outlined the challenges that lie ahead and how we might best deal with them.

The most significant aspects are as follows.

It is the member states who hold the key to sustainably overcoming the crisis in Europe.

> The European banking system, the member states and the European regulatory framework have to be made more crisis-resistant so that the euro area can return to a path of sustainable growth.
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> As I mentioned earlier on, there's plenty of good news at all three of these levels.
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> But that doesn't mean we can declare the crisis over.
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> The adjustment process in the crisis countries is likely to continue for quite some time.
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> The tightened regulatory framework needs to be applied more forcefully in practice and additional measures will have to be introduced.
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> Ultimately, the only way to overcome the crisis ...
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> ... is to gradually rebuild confidence.
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> But this is only possible if the euro area consistently maintains its stability course.

As far as the euro area is concerned, I see no reason to be overly pessimistic. What matters is that the member states continue to muster the will to rigorously tackle the root causes of the crisis.

I began this speech with a reference to Walter Hallstein's conviction to the effect that: "Whoever does not believe in miracles in European matters is not a realist." But where do I stand with regard to this quotation now that my speech is coming to a close?

Well, as I see things, we do not need any miracles in Europe today.

> The foundations for achieving stability in the euro area are already in place. However, these need to be enhanced in some important respects and they should be rigorously enforced.

It will not be a walk in the park. But neither is it the stuff of miracles.

Thank you for your attention.