Andreas Dombret: The euro area – where do we stand?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the American Council on Germany, New York City, 4 December 2015.

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1. Introduction

Ladies and gentlemen

Thank you for inviting me to speak here today. Attending ACG events is always a pleasure for me.

"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." These words will sound very familiar indeed to anyone who closely follows contemporary politics in Europe. They were spoken back in 1954 by Germany's first chancellor Konrad Adenauer in remarks underlining the need for a unified Europe.

Since then, European integration has proven to be extremely successful in securing peace and economic prosperity, but there have also been shocks along the way which have threatened all these achievements. Europe has learned its lessons. We have set far-reaching reforms in motion at both the national and the European level. But we're not finished yet.

2. The euro area – current challenges and recent achievements

Structural problems in the euro area need to be tackled with "structural solutions". Monetary policy, then, is not a panacea. It cannot resolve the crisis, nor can it put the euro area back on a solid footing. That's something that only structural reforms can achieve.

At this point, I would like, if I may, to say a few words about yesterday's decision by the ECB Governing Council. First things first: the Eurosystem staff macroeconomic projections presented give no cause for concern over the development of the euro-area economy. In fact, they confirm the view that the steep drop in energy prices is supporting the recovery of the euro area's economy. The lower energy prices also go a long way towards explaining the expected evolution of consumer price inflation.

It's clear that inflation as forecast by the Eurosystem staff will fall short of the Governing Council's price stability target not only in 2016 but probably into 2017 as well. That's not something we should simply brush aside. But given the predominant role which the drop in energy prices plays in euro-area inflation and the extensive monetary policy measures that have already been taken – which can entail risks and side-effects of their own – I am not really convinced that a further easing of monetary conditions was necessary.

As I just said, monetary policy is not an all-purpose tool. Thus, I would like to come back to European reform efforts.

Let's look briefly at the national level. When the euro-area crisis erupted six years ago, many people dubbed it the "euro crisis". However, it was not a currency crisis so much as a cocktail made up of one part debt crisis, one part banking crisis and a good size shot of a balance of payments crisis.

A combination of hugely overambitious growth expectations, waning competitiveness caused by generous wage settlements, and insufficient financial regulation caused sizeable imbalances to accumulate which then helped fuel the crisis.

Hence, it is the countries themselves that need to adjust if the crisis is to be resolved. And it was clear from the outset that the necessary reforms and adjustment measures require patience. Major progress has been made in the meantime, with most of the crisis-ridden countries having succeeded in substantially improving the state of their public finances. Current account deficits have largely been pared back, and several countries are now running a surplus. Price competitiveness in the crisis countries has also improved significantly. Unit labour costs have contracted by 18% in Ireland, 5% in Spain, 4% in Greece, and 1½% in Portugal.

The finishing line is still some way ahead of us, but there is much to suggest that our efforts are paying off. But like in a marathon, the last few miles are always the toughest ones. And yet it is the final stretch that determines the final result. That's why we must not falter in our efforts to pursue productivity-enhancing reforms which alone can provide a sound footing for stronger growth.

Suffice it to say, correcting misalignments solely at the national level doesn't go far enough. What we also need are structural reforms at the European level. And here, we've made a great deal of headway since the onset of the crisis.

First, the rules of the Stability and Growth Pact were changed and a fiscal compact was adopted to restore confidence in public finances. Second, a procedure for identifying macroeconomic imbalances early on was put in place. And third, a crisis mechanism – that is, the European Stability Mechanism – was set up to act as a firewall safeguarding the stability of the financial system in the euro area.

3. Banking union – the SSM's first anniversary

On top of all this, major reforms were implemented in the European financial system itself. It is now thirteen months to the day since the euro-area countries took the greatest stride towards deeper financial integration since the launch of the euro. On 4 November 2014, the European Central Bank took charge of directly supervising the largest, most significant banks in the euro area – a step which erected the first pillar of a European banking union. As of today, the ECB supervises 123 banks which together account for more than 85% of the aggregated total assets of the euro area's banking sector. That makes the ECB one of the world's largest supervisors.

To me, the banking union is the most logical step to take in advancing and completing our monetary union. This is because the euro area's single monetary policy relies on a deeply integrated and resilient financial system to be effective and efficient in pursuing price stability. Indeed, European financial markets were already interconnected prior to the euro crisis. But it was the arrangement by which national authorities were solely responsible for banking supervision which sparked a build-up of risks that finally spread across the entire Union, gravely endangering its very existence.

This experience gave way to an understanding that banking supervision needed to be shifted to the European level. That step has delivered three concrete benefits.

First, European banking supervision enables banks throughout the euro area to be supervised in a uniform manner and subject to the same high standards. These harmonised standards will emerge as national supervisors share their experiences with their international peers and adopt national best practices in banking supervision at the European level.

Second, European banking supervision makes it possible to effectively identify and manage cross-border challenges. This is a crucially important point because large banks usually operate in more than one country.

Third, switching banking supervision from the national to the European level will add a degree of separation between supervisors and the banks they supervise. This will prevent supervisors from handling "their" banks with "kid gloves" out of national interest.

As you can see, we have placed high hopes in European banking supervision. Today, thirteen months on from the establishment of the Single Supervisory Mechanism – or SSM for short – it's time to take a first look back.

We are already seeing the benefits of the new regime in our day-to-day business. There are 123 mixed joint supervisory teams – or JSTs for short – for the banks directly supervised by the ECB. Bundesbank supervisors belong to 22 JSTs for German banks and to 12 host JSTs for foreign banks. Such a cross-national dialogue is probably the most productive way to uncover and discuss idiosyncratic supervisory routines.

Furthermore, a level playing field and cross-border supervision are facilitated within the SSM area. The European Single Rulebook and the European Banking Authority naturally have a part to play in this development. But when it comes to the cross-border supervision of a banking group, institutional dialogue at the JST level has proven rewarding. In addition, the ECB is about to harmonise its use of roughly 100 regulatory options and discretions that were intended for specific national situations but which produced an inconsistent framework in the SSM area.

Overall, I hear that banks consider their new supervisory counterpart to be "tough but fair". In today's challenging financial environment, I am inclined to read this feedback as a compliment for the SSM as a whole, that is the ECB and the national supervisors. We are performing two roles at once: that of a referee ensuring fair play and a level playing field, and that of a diligent doctor who makes sure our patients remain sound and healthy – but prescribing a bitter pill if need be.

It goes without saying that, for all its success, a project on the scale of the SSM won't get from nought to sixty in the blink of an eye. Improving processes and cultural learning take time. And there is no doubt that it will be an ongoing challenge to ensure a consistently high level of supervisory quality that reflects both banks' individual risks and their changing environment.

So the challenges faced by the SSM are multifaceted. They concern transparent and unbiased processes, timely and effective decision-making, avoidance of rivalry between national dogmas and the promotion of a cooperative quest for appropriate solutions – to name just a few. One of the SSM's greatest strengths is its wealth of supervisory knowledge and experience, resulting from the close interaction between the ECB and the national supervisors. It is our task to develop this wealth of competences in the most efficient and effective way. I am thus arguing, in essence, for a balanced mix of centralised stringency and national diversity.

There are also some more fundamental challenges which the SSM needs to confront. First, one reason for launching the SSM in the first place was the need to decouple bank risks from sovereign risks. But the sovereign-bank nexus should not be replaced by one linking banks and central banks. Moreover, I am convinced that untying the Gordian knot between banks and sovereigns requires not just a pan-European supervisor but also adjustments to the regulatory treatment of sovereign exposures. I will come back to this issue a little later on.

Second, the ECB now plays different roles in our monetary union: it's a microprudential supervisor, a macroprudential watchdog and the monetary authority all rolled into one. Hence, banks are both the ECB's business partners when it comes to monetary policy and its supervised entities. I'm not denying that there are synergies between these tasks with respect to financial stability, but unintended symbioses are possible as well. It is especially with respect to institutions that are likely to fail that I fear that political incentives might go astray. In the long run, I therefore call for a strict line to be drawn between supervisory powers and monetary decisions.

Meanwhile, a comprehensive banking union has to comprise more than just effective European banking supervision. The second pillar of the banking union is a European resolution mechanism – the Single 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 the resulting losses, with taxpayers' money only being tapped as a very last resort. This will realign incentives and make the entire banking system more stable.

That being said, I take a very sceptical view of the third pillar of the European banking union – that is, the European deposit insurance scheme. The current plans lack crucial prerequisites for entering into such a framework. Even though the SSM contributes significantly to the stability of the European banking sector, banks' well-being is still largely determined by national policy decisions. For instance, bankruptcy law is highly heterogeneous among EU countries. Moreover, sovereign debt still enjoys preferential treatment in banking regulation, incentivising banks to be overexposed to government debtors. In such an environment, a European deposit insurance scheme would result in Eurobonds being introduced through the back door.

4. Capital markets union – the next step to take

Although the European financial system is still dominated by its banking sector, Europe has to broaden its view beyond banks to achieve a comprehensive framework. Thus, the next big step for Europe will be to establish a capital markets union. Strengthening capital markets and integrating them across borders will deliver at least two major takeaways.

First, it will improve access to funding for small and medium-sized enterprises especially, thus sowing the seeds for stronger and more resilient economic growth.

Second, integrating capital markets across national borders will improve risk sharing. The US is a model in this respect. Here, integrated capital markets cushion around 40% of the cyclical fluctuations among the US federal states. An additional share of 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.

In Europe, by contrast, it is mainly credit markets that cushion economic shocks – and not particularly effectively at that. Altogether, only around 40% of a given shock is absorbed before it can affect consumption. A capital markets union would therefore help to improve risk sharing in Europe and reduce the volatility of consumption.

Last but not least, the recent crisis shed light on the real economy's funding mix 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.

Therefore, the objective of the European capital markets union is not to abandon bank-based financing but to supplement it with capital markets-based funding. And in Europe there is plenty of scope to do so. The European stock market is only 60% the size of its US counterpart 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.

The capital markets union is a complex undertaking affecting many different areas, hence the broad range of proposals and suggested actions presented by the European Commission. Nevertheless, I firmly believe that Europe should embark on the path towards a capital markets union to enhance the stability and prosperity of its economy.

5. Conclusion

Ladies and gentlemen

Europe has many success stories to tell, and it has demonstrated that it is willing and able to adjust to economic and political necessities. We have introduced plenty of reforms and are now beginning to reap the rewards. Above all, major steps have been taken to deepen integration in Europe's financial systems – in particular the continent's banking system.

The SSM can look back on a very successful first year indeed, and it will contribute to a more stable financial landscape. However, our work is far from over. Yes, the launch of the Single Resolution Mechanism is just around the corner; but when it comes to the regulatory treatment of sovereign debt and the capital markets union, there are still many challenges to resolve.

And I am convinced that Europe will overcome them all, if only for one good reason: “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”.

Thank you for your attention.