Andreas Dombret: Monetary integration - lessons from Europe

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 2017 Symposium "Monetary Integration Prospects in Africa: Lessons from the Experience of the European Monetary and Financial Integration", Pretoria, 15 August 2017.

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1. Introduction

Ladies and gentlemen

It is a pleasure to be in South Africa once again – it is definitely one of my favourite destinations in the world. And today's conference shows that there are many topics that Europe, South Africa and Africa share as a whole. In fact, many people outside of Africa are not sufficiently aware of Africa's quite rich experience with economic and monetary integration, and with existing as well as planned monetary unions across the African continent. In the next 20 minutes or so, let me do my part in an exchange of lessons learnt from monetary integration.

You could write the idea of a monetary union on the back of an envelope. And to list its potential costs and perils, you might manage with a one-pager. But when it comes to documenting the workings of an actual monetary union like the European project, this means many thousands of pages of strategy papers, political compromises and new regulations, not to mention the changes it brings to people's lives. The project of monetary integration in Europe turned out to be not only a number of steps, but rather a journey.

I guess that all of you here at this conference have made similar experiences across African countries and across existing currency unions.

Where does this complexity derive from? And what could be valuable lessons for future steps of monetary integration elsewhere?

Let me spend the next 20 minutes or so on a high altitude flight over the European monetary union and both its structural impediments as well as its reform challenges.

2. Economic perspective: Between asymmetries and convergence

People still have vivid memories of the crisis in the euro area. Just picture all-night meetings between national leaders, emotional debates in the European Parliament, European citizens queuing in front of closed banks, central bankers in many conference calls or young workers leaving their country to escape unemployment. These images somehow point – amongst others – to unsolved issues of European monetary integration.

But the problem with those images is that they always tend to give only a partial and situational account of the problems. The actual issues of a monetary union are a lot less visible and a lot more abstract. So it is part of our job as central bankers and international economists to explain these phenomena – also by giving technocratic speeches that aren't much fun to listen to. And as we're still at the beginning of this conference, I'll try to concentrate on the very fundamentals.

In economic terms, we have to deal with asymmetries – imbalances that exist for a longer time or that build up slowly over time. There may be differences in economic development, but we should not abstract from differences in infrastructure, institutions, and political and economic philosophies. All of those differences across borders are quite common.

You may be thinking of specific regional disparities among African countries right now. But also in the euro area, "convergence" was a key word from day one. Even today, although almost all

member states in the euro area are experiencing an economic upturn by now, economic cycles are not synchronous. And unemployment rates are highly divergent, standing at over 22 percent in Greece and below 7 percent in Ireland. So even 25 years after we initiated a far-reaching treaty of European integration, and after 18 years of sharing a common currency, we are not marching in step.

Those asymmetries and structural differences between neighbouring countries are not necessarily a bad thing. But in a monetary union, dissimilar developments have extensive implications for two important challenges: first and well-known to everyone here in this room, given its construction, a monetary union is more prone to imbalances because there is no longer a national currency with a floating exchange rate as a means of countering imbalances and regional economic shocks. However cruel a sudden revaluation may be for some parts of an open economy, it is very useful as an automatic response to crises. Without nominal exchange rate flexibility, economies need to adjust through adjustments of the real exchange rate which is much more painful in practice.

As a second challenge, in a monetary union the community may ultimately bear the consequences for imbalances that have emerged on the level of sovereign member states. This has been an unequivocal lesson from the crisis in the euro area.

To describe how asymmetries became imbalances, let me briefly recap that large capital flow imbalances had built up for several reasons in the run-up to the crisis. Then, suddenly, a mistrust overburdened regional financing, the economy, and especially fiscal cushioning powers. But there is no need here for details about the ultimate causes that led to the crisis. To understand structural flaws in the euro area, it is more important to concentrate on what followed. Because what the course of the crisis quickly revealed is that the euro area was unprotected against spillovers and contagion.

So, with hindsight, one can argue that Europe had underestimated the ways in which economic and structural asymmetries transgress borders and challenge European institutions. There were multiple channels, such as financial risks, economic risks, political risks, and even euro area monetary policy appeared as a last resort – because former national lenders of last resort no longer existed.

Let me add a side note. People sometimes wonder why the discussions around the euro area have not really followed the line of economic textbook logic. My first comment on that is that sudden external shocks haven't played a major role in the wake of the crisis. Second, ordinary channels that are meant to dampen the magnitude of negative developments have not been central to developments. For example, we have witnessed a temporary net flow of workers from countries hit hard by the crisis to countries with stronger economies. But another channel, that of capital flow, has even aggravated imbalances to some extent. Cross-border capital turned out to be volatile, especially with respect to countries struck by crisis. We have even witnessed pro-cyclical behaviour with respect to savings and indebtedness.

So, because economic burdens could not be absorbed within their supposed boundaries, the euro area community was found to be ultimately accountable for the imbalances. The chief diagnosis therefore was, and still is, a mismatch between instruments and responsibilities.

How to resolve this problem? Let me present the basic modules, on which I sense an overarching consensus in all parts of the euro area. To be frank, there are also disagreements about reforms in the euro area, and I will turn to those later on.

Without a national lender of last resort and without the option of immediate fiscal stabilisation, there was a need for an effective euro area crisis response. Mechanisms were established to contain liquidity shortages. We also saw a determined monetary response. But of course, immediate crisis response mechanisms tend to favour short-term containment over long-term

effectiveness. We are currently still debating incentive structures of immediate crisis management. But it was clear from the beginning that we would have to move from proximate to ultimate fixes as soon as possible.

An important next step was to tackle amplifiers and aggravators of the crisis. Let me specifically refer to banks in the euro area. Banks were involved in capital flows between member states, and they were involved in government lending, which fed into the so-called sovereign-bank nexus. This is the unhealthy relationship between governments and their banks, whereby banks lend on a large scale and without a capital charge to their home countries, while governments simultaneously find they must support struggling banks in order to prevent an immediate crisis. Apart from the vicious circle I have just described, the bank crisis amplified adverse developments through various channels like overall bank mistrust, contagion effects as well as fire sales.

The basic lesson was – and is – that the health of the euro area very much depends on healthy banks. While it is a hypothetical question whether sounder bank behaviour could have prevented the crisis entirely, we can be certain that a sound banking system that is equipped with more capital and is incentivised in a healthier way makes crises a lot less likely. A major consequence of the crisis has therefore been the so-called banking union – a change in rules and institutions governing euro area banks. Of the various reforms the euro area has witnessed in the last years, I find that these reforms have had the greatest impact so far. Even though the European banking system is still recovering from severe shocks, larger capital cushions have been built up and there is much greater emphasis on risk management today.

But of course this doesn't answer the question whether the union with all of its rules and institutions could – after leaving the crisis behind – become inherently stable in the future. Asymmetries and structural differences will remain a potential source for imbalances in the future as well. Or as the famous American Air Force engineer Edward A Murphy put it: "Anything that can go wrong will go wrong."

Therefore, we are still confronted today with the task I mentioned earlier, namely that of resolving the mismatch between instruments and responsibilities in the euro area. Whatever the solution will be, it has to be somewhere in the spectrum of either transferring more responsibility to the EU level or filling all of the gaps in national responsibilities. There are plenty of reform options under discussion right now in Europe.

In any case, straightening out the relationship between individual countries and the monetary union should not be the sole focus. The euro area also needs to continue its work towards strengthening market functioning and market discipline.

Because whatever institutional setup a monetary union has, markets remain part of the story. They need to exert their power effectively and responsibly – in good times and in bad. It follows a simple logic: once losses occur, someone has to accept responsibility for these losses. In the euro-area crisis, markets – understandably – put a lot of effort into evading their responsibilities. We are still struggling to make markets and banks a reliable cushion in times of economic distress.

3. The reform perspective: Bridging differences

Ladies and gentlemen

So far I have attempted to give a high-level summary of structural flaws affecting the European project. These may well be valuable lessons for further economic and monetary integration in Africa. But that is only part of the story. As you may well imagine, there is an all-too-easy storyline of first identifying structural flaws and then invoking a comprehensive reform.

There are two obstacles I wish to address in that context. They have so far played a role in the euro area, but they probably apply at a fairly general level, too. The first is essentially that we are not on a green field where we can implement reforms without constraints. In Europe, it was well-known in advance that monetary policy would not become a cure-all and that problems like national fiscal overload were likely to emerge. But legal provisions have so far simply lacked reliable enforcement. Therefore, an important lesson of the euro area is that common rules need to be credible at all times.

However, we now have to live with the fact that the fragilities that fed into the crisis partly continue to exist. Whether a flourishing regional economy, fiscal solidity or the financial resilience of banks – they all interact systemically – in good and in bad times. So how much patience should we have for each of the patients? Europe will have to continue walking a thin line, balancing short-term expediency and long-term efficiency of reforms.

But the green field for reforms doesn't exist for another reason, and that's because actual consensus on reform options is not entirely clear. This is the second obstacle to reforms. It doesn't only relate to the long-term path of the union, but to crisis resolution options as well. This is because all of these matters somehow interfere with the economic and political sphere of national states – which unsurprisingly want to retain their influence. Thus, whatever institutional compromise is aimed at on the European level, it will touch on delicate national economic doctrines. This has been even labelled the "battle of ideas" about the euro.[1] It comes about quite naturally: reform solutions are built on narratives about causalities. And narratives about causalities quickly lead to responsibilities. In Europe, quite resilient, opposed narratives have evolved in parallel to divergent economic realities. And in keeping with the confirmation bias, it tends to be easiest to find evidence for one's own theory. This is why consensus about the scope of European responsibilities is still a matter of debate beyond those about restraining national powers. For example, the EU as a centralised entity that could mitigate imbalances would require a common understanding of good economic policy. So the challenge is not only about bridging differences in economics, but also about bridging gaps in ideas and political attitudes.

4. Conclusion: Easy to explain, tough to maintain

Ladies and gentlemen

Monetary integration is easy to explain, but tough to maintain. It usually comes with additional necessities, for each participating country and for the community as a whole. During my speech, I have emphasised both structural and reform challenges in the euro area.

But of course, you won't be presented with the full picture of the European project even from a central banker. This is because even though it is not (yet) a political union, it is to a great extent a political project. Its worth can hardly be measured in economic terms alone. In fact, economists have frequently been surprised at the determination of integrationists. In all parts of Europe, the union is not only seen as part of the problem, but usually also as part of the answer. Recently, amidst a wave of euro-scepticism, people in my town of Frankfurt held weekly demonstrations in support of Europe.

In this respect, the monetary union contributes to a search for common solutions as an – if you want to call it that – "automatic response" to political isolation. Our union compels us to seek common solutions instead of separate policies.

Being here in Pretoria I of course wonder what role this drive towards common solutions could play in Africa in the future.

If you ask me, it does not make structural challenges any easier. But if a currency union is not just a number of steps but a journey, I find it very comforting to see the determination and strong

will of all the travellers on that journey.

Concerning the future path of monetary integration in Africa, my hope is that this conference will become a memorable signpost.

Thank you very much for your attention.

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[1] Brunnermeier, James and Landau 2016: "The Euro and the battle of ideas".