Andreas Dombret: Five theses on the future of Europe

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the ESMT Open Lecture, European School for Management and Technology (ESMT), Berlin, 14 February 2018.

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Dear Jörg Rocholl

Ladies and gentlemen

Thank you for inviting me to speak at the ESMT Open Lecture. During my last visit to this university, I had the gratifying opportunity to moderate a speech delivered by Christine Lagarde.

My talk today will be about the future of Europe, and of the euro area in particular. Currently, the euro area is witnessing a fully-fledged economic upswing. At year-end 2017, GDP had climbed by 2.4% overall. And the outlook is looking positive as well. Many have upgraded their growth expectations – Eurosystem staff projections for 2018 are at 2.3% for 2018. Sentiment levels are at long-term highs. All these indicators suggest that momentum is strong in the euro area economy. What seems equally important is that the upswing is broadly based, meaning it has reached many countries and many regions.

But of course, we cannot speak of synchronous developments, as countries still differ in terms of infrastructure, institutions, and political and economic philosophies – and for that matter, economic developments, too.

Apart from that, the current upswing should not distract from existing issues. Banks in several member states are still saddled with huge volumes of non-performing loans. Across the European Union, they amount to about € 950 bn. At the same time, some member states are still vulnerable due to high levels of public debt.

Furthermore, indicators such as banks' holdings of sovereign debt issued by their domestic government suggest that the strong connection between a country's government and banks domiciled there – the "sovereign-bank nexus", as it is known and which had played an important role during the euro crisis – continues to exist.

Finally, less than a year ago, populist movements which strongly opposed the euro area and the EU were perceived as a significant threat. While their political influence turned out to be rather low, risks do remain.

All in all, there are a number of good reasons to reflect on the future of Europe. I would like to use this ESMT Open Lecture to discuss the following five theses.

1. First things first for the euro area financial architecture

The financial architecture in the euro area still has its weaknesses today, even following years of recovery and after various far-reaching reforms – think of the banking union, for example. Among politicians and central bankers, this is common knowledge, so to speak. Lately, discussions on how to proceed have picked up pace again. As far as the banking union is concerned, this debate has centred around the European deposit insurance scheme, or EDIS for short, which should be its third and final pillar.

I'd like to refute any suggestion that Europe is facing a standstill in discussions because the proponents and critics of further reforms are allegedly refusing to shift from their positions. If we want to pave the way for a more resilient union, "wait and see" is not an option, given that financial architecture improvements are not just “nice to have” for the euro area. In fact, the Bundesbank generally backs the idea of a European deposit insurance scheme, provided all preconditions are met. And as far as fiscal and macroeconomic safeguards are concerned, we endorse several concrete reform options such as adding surveillance of national public budgets to the powers of the European Stability Mechanism, or ESM for short.

The point I’m making has more to do with the sequence of reforms than whether or not to reform. My thesis is: first things first.

To illustrate my point, let us take a look again at the sovereign-bank nexus, which has been at the epicentre of the euro area crisis. As we have witnessed during the crisis, the unhealthy relationship between euro area member states and their domestic banks can trigger what is known as a “doom loop” – a downward spiral which comprises banks, the government, and the entire national economy.

When thinking about making further reforms to the euro area financial architecture, it is important to bear in mind that this “doom loop” may be caused both ways. One cause is struggling banks. They induce their government to come to their rescue if no reliable and credible resolution mechanism is in place for banks. All of us here in this room will recall government rescues in several countries of the euro area – Germany being one of them. With these gloomy episodes in mind, it is entirely conceivable that in severe cases, bank rescues can overburden a country’s fiscal capacities.

We have already reached several milestones on the road towards eliminating this channel of the sovereign-bank nexus. I am referring here specifically to the European resolution regime. At this point of the journey, the next milestones concern realigning the European resolution framework and its national counterparts, and banks building up bail-in-able capital in order to meet their MREL targets. Once these tasks have been completed, the rules will do their part to reduce the sovereign-bank nexus.

But as I indicated, there is also the other direction of causation, namely fiscally overburdened states possibly infecting their own banking system and triggering a solvency crisis at banks. Again, this is more than merely an academic thought experiment: today, banks still have large undiversified stocks of sovereign bonds on their balance sheet. That means that we have good reason to be concerned. And unlike the first contagion channel I mentioned, this problem has not been dealt with from a regulatory point of view. Quite the opposite, there is a regulatory privilege that encourages banks to buy government bonds: at present, sovereign bonds from member states of the euro area have a zero risk weight under the capital requirements regime – this means, essentially, that the positive economic risk attached to sovereign debt is not reflected in capital requirements. Nor is there any upper limit for exposures to specific sovereigns. Remedies aren’t hard to find: they consist of non-zero risk weights as well as concentration limits for sovereign exposures.

Addressing sovereign concentration risks on banks’ balance sheets should be a top priority in further reforming the euro area financial architecture.

So in this context, how should we evaluate reform options such as a European deposit insurance scheme?

Looking at struggling banks and their potential negative impact on financial stability, confidence plays an important role. In this context, EDIS is seen as an additional safety net alongside the earlier lines of defence, such as capital buffers and MREL. Its purpose is to maintain depositors’ confidence in their banks and to prevent a potential bank run. Now, I could spend a lot of time discussing the difficulties involved in constructing a European deposit insurance scheme of that kind, and reflect on existing national schemes, which already have to fulfil Europe-wide minimum standards today.

Here I would like to focus on the connection between EDIS and the sovereign-bank-nexus. Given that core structural weaknesses brought about by a sovereign-bank nexus continue to exist, additional safety nets are not only less effective, but may even turn out to be counterproductive. And there are two reasons for that:

1. Given that the sovereign-bank nexus works in two directions, any argument about all-European responsibility for deposits is off the mark. How is the euro area community, represented by European supervisors, supposed to assume responsibility for bank failure and give access to funds if they did not have an instrument in place to address sovereign risk beforehand?
2. With additional safety nets in place, incentives to act prudently and responsibly decline. Also, these safety nets will make reforms of high-priority issues less pressing. This argument is valid not only for EDIS, but also for reforms of other mechanisms functioning as safety nets in order to stabilise the financial sector or the economy, like the ESM.

Maintaining reform pressure and reducing risks before establishing a common safety net certainly extends beyond eliminating current privileges for sovereign bonds in banking regulation. It pertains to all excessive risks currently identified in national banking systems. Allow me to comment on one of these risk categories later in my speech, namely on large amounts of non-performing-loans in banks in several member states.

These remarks do not mean that I am dead set against a reform of deposit insurance. I am talking about putting the reforms in the right sequence. So my first point is that if we want to improve the structural design of the euro area, we need to address the sovereign-bank nexus – amongst other things – before we create a European deposit insurance scheme. In other words: let's do first things first.

2. No painless way out

My second proposition is this: however we seek to rectify an imperfect financial architecture, it won't be painless.

Overhauling the less-than-ideal statics of a financial construction isn't a simple task, as you see; it won't happen soon, and it will involve stress. But there is no easy alternative to it.

This can be seen if you take a look at discussions surrounding what are known as sovereign bond-backed securities, or SBBS for short. There is no question that this financial instrument is interesting from an academic point of view.

But are they interesting as a policy option given the weaknesses of our current financial architecture? Some proponents have argued that SBBS could serve as a helpful financing tool, for example because they could automatically diversify sovereign risk and at the same time – supposedly – involve no collective risks whatsoever for the European community (even in times of financial stress), I am not convinced, however.

In order for SBBS to function properly, quite a number of factors have to be considered. For example, collective risks which might emerge due to bridge financing or also guarantees need to be precluded. But I won't go into all the constructional details.

Let me jump straight to the key argument with respect to the sovereign-bank-nexus: SBBS will not function without the aforementioned reforms of sovereign exposures in the regulatory rules for banks. So this is a necessary precondition. Given the current privileges for sovereign bonds in capital requirements calculations of banks, they have strong incentives to buy these bonds directly. For SBBS, there would not be any such regulatory privileges and thus a market for SBBS would not emerge.

Now some have called for a comparable privilege of SBBS in banking regulation. But this is no option, either: if we want regulation to be risk-adequate – which means it needs to take into account the non-zero risk of government default – this has to pertain to any financing instrument for sovereigns, including SBBS. Otherwise we would have merely relocated financial stability risks. These securities, then, do not offer an easy way out.

3. More than rules: rigorously target high-priority risks

Sometimes it seems that all that representatives from German institutions have to say about Europe is that it needs to adhere to a strong set of rules, and that rules need to ensure that those who are in control of risks and opportunities also bear the consequences.

I have two things to say about this.

To start out with: I am a strong proponent of these ideas. As abstract as they may sound in a speech, a lot of empirical evidence and day-to-day wisdom went into them.

The second is: Europe's future does indeed require more than a well-balanced architecture. In the following, I will concentrate on those other fields.

First and foremost, we have to rigorously target the risks we are already aware of. And those who are familiar with SSM supervisory priorities will know that I am about to speak on the issue of non-performing loans, or NPLs for short.

My point here is this. The European supervisors should, in my view, not hesitate to vigorously pursue this issue and to address it as soon as possible. Not only because it remains a threat to the stability of the banking system in the euro area, even though capital cushions have significantly improved at banks across the common currency area. Not only because we need to address these legacy risks before moving on with reforms that incorporate risk sharing across the euro area.

But – importantly – because NPLs actually impede the recovery of individual banks and national economies. NPLs consume a lot of time and attention in credit institutions, and we have experienced that banks preoccupied with large amounts of NPLs are very hesitant in terms of new business. This creates bad long-term prospects not only for the individual banks, but also for regional economic recovery, which may be slowed down significantly. Against this backdrop, I also acknowledge the considerable progress made by individual SSM banks in cleaning up their balance sheets in 2017 – not only because mounting supervisory pressure forced them to do so. But also because the improvement of asset quality creates long-term value for their stakeholders.

In that vein, let us not dwell on supposed European conflicts of interest surrounding the treatment of NPLs. I propose that we see this as a conflict between short-term and long-term regional interests. Therefore, I strongly support the take of European supervisors on this matter.

4. Resilience is not a state, but a process

My fourth point is: resilience is not a state, but a process. To make this point, there is no better example than cyber risks. Here at the ESMT, where the "T" stands for technology, I don't have to convince anyone that if you want to get the full picture of where the economic and financial systems are headed, you have to take a close look at IT topics and IT solutions.

From the viewpoint of a banking supervisor, even though a lot of our daily work is centred around capital requirements – which some have called the magic bullet of banking regulation –, cyber risks and other IT-related risks are quite special, for even in adequately capitalised banking systems, this doesn't prevent IT-related financial stability issues from occurring, such as downtimes in payment systems (or massive manipulation of financial ownership). Thus, financial supervisors need to target those risks in a direct way, pushing the financial sector to make incidents less likely and emergency responses as effective as possible.

So what is the European dimension here? Well, it is all too easy: in cyber space, there are no borders, hence the ease with which cyber risks transgress national boundaries. We have to be sure to target all the weak links. This especially refers to infrastructure prone to cyber attacks.

And Europe has acted already, albeit largely unnoticed by the public. The Directive on security of network and information systems, or NIS Directive, which was adopted by the European Parliament in the middle of 2016, obliges member states to be adequately equipped and to establish minimum standards for important infrastructure. It also fosters cooperation among member states in cybersecurity measures. And I can say that this European stimulus has even reached the realm of national banking supervision: we are currently working on aligning various supervisory standards with the requirements for critical infrastructure.

Also, Europe offers opportunities to join forces in combatting cybercrime. As attack methods constantly evolve, and given that there is no once-and-for-all cure for cyber threats, our best response is to evolve as well. Mutual learning is generally a good thing, but in a digital environment it is hugely important, because we cannot build on a long history of best practices, and it is a setting where small mistakes might be very costly. And I am happy to say that, for banking supervisors, interaction with colleagues from other countries is already part of our day-to-day business.

5. Europe's problems have to be understood

So far, I have presented you with four rather bureaucratic propositions. But is this really all there is to Europe's future – a bunch of good recipes developed by experts?

Technocrats will have to concede that while we may alter rules and change incentives, this will not resolve discussions about Europe altogether. We have witnessed a surge in nationalism and populism in several member states. And since the Brexit referendum, we know full well that criticism and doubts about the European project (however well founded) won't just come and go every so often.

Now I am well aware that perceptions about Europe are of a very complex and multifaceted nature – and I cannot and will not run an in-depth analysis here.

But there is one issue which most perceptions about Europe share and which I am quite familiar with – because we happen to encounter it in our own educational work at the Bundesbank. It is the sheer complexity and high level of abstraction of European economic matters. In discussions on Europe, economic topics such as the financial crisis or the euro area crisis play an important role. And for the general public, these matters are not at all easy to comprehend. In fact, you yourself can only grasp the speech you are listening to in this very moment because of your knowledge of this field.

At the Bundesbank, we are ourselves engaged in economic education. After all, monetary policy reasoning can only be successfully communicated if the general public have a basic grasp of terms such as inflation or interest. One major takeaway from our work – be it in schools or at educational events offered for the general public – is: nothing happens by itself. We need to foster an understanding of the economic and financial topics in Europe and in the euro area. At times when populists come up with supposedly simple solutions, this is becoming more important than ever.

My point concerns not just economic education – it goes for political education as well. It is the task of political education to adequately communicate European ideas and values, especially to younger generations. It is about highlighting the advantages of European cooperation. It is about providing citizens with the tools they need to understand and classify issues around Europe.

Thank you for your attention.