Dr Andreas Dombret
Member of the Executive Board
of the Deutsche Bundesbank

The State of Europe:
End of the crisis or crisis without end?

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Deutsche Bundesbank, Communications Department
Wilhelm-Epstein-Strasse 14, 60431 Frankfurt am Main, Germany, Tel: +49 (0)69 9566 3511 or 3512, Fax: +49 (0)69 9566 3077
presse@bundesbank.de, www.bundesbank.de

Content

1 Introduction

President Fisher
Vice President Wynne
Deputy Consul General Kroll
Mr Heppe, American Council on Germany
Mr Langenau, German American Chamber of Commerce
Ms Colton, Dallas Committee on Foreign Relations
Ladies and gentlemen

Thank you for inviting me to speak at the Federal Reserve Bank of Dallas. It is a great pleasure to be here today. In fact, it feels a bit like coming home. And this is not only due to President Fisher's remark that the Fed of Dallas is the Bundesbank of the United States.

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There are three further reasons why I feel at home over here. First, I was born in the United States and I still carry an American passport in addition to my German one. Second, the state of Texas has a rich German heritage. A heritage that finds its most vivid expression in the numerous *Oktoberfests* that take place in Texas every year – including the world-famous New Braunfels *Wurstfest* or "10-Day Salute to Sausage", to use the phrase with which it is promoted. Third, the city of Dallas is very familiar to many Germans of my generation because in the 1980s, we all watched the TV series of the same name.

But TV shows and *Bratwurst* are not the only ties that bind the United States and Germany. The connections between our countries are manifold and profound. These close connections are promoted and fostered by institutions such as the American Council on Germany or the *Atlantik-Brücke,* of which I happen to be treasurer.

In times of crisis, mutual understanding and a trustful relationship are particularly important. And since 2007, we have lived through a succession of crises: a global financial crisis, a worldwide recession, a sovereign debt crisis in the euro area and, most recently, turbulence in some emerging markets.

These episodes have once again underscored how closely interconnected the global economy has become. What drives growth and prosperity in good times can easily turn the other way in a crisis. In a globalised world, a problem at one side of the globe can quickly spread to the other side. To

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paraphrase Winston Churchill: “a financial crisis gets halfway around the world before policymakers have a chance to get their pants on”.

In a globalised world, what happens in the United States is relevant to Europe and what happens in Europe is relevant to the United States. Against this backdrop, I wish to shed some light on the situation in the euro area and offer you an inside view.

2 The end of the crisis is slowly getting closer

For nearly four years now, the state of the euro area has been defined by the sovereign debt crisis. And indeed, one might get the impression that this is a crisis without end. However, I have good news for you. The end of the crisis is slowly getting closer and closer. Most importantly, the euro area as a whole has finally left recession. By now, we have seen three consecutive quarters of positive growth, and looking ahead, the outlook for this year and next year is also quite encouraging. Projections by the ECB suggest that euro-area GDP will grow by just over 1% in 2014 and by 1½% in 2015.

And this recovery is not only driven by the “core euro-area” countries such as Germany. Some of the crisis-hit countries have also finally embarked on the path to recovery. And those which have not can at least see the light at the end of the tunnel.

It seems that the efforts to implement structural reforms are gradually bearing fruit. Competitiveness has improved in most peripheral countries

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over the past few years. Almost everywhere, unit labour costs have fallen substantially. Improving competitiveness in turn drives exports higher. All peripheral countries – except Cyprus – are projected to see some export growth this year. These achievements are reflected in current accounts increasingly reverting to positive balances.

And Germany is part of this rebalancing equation. Since 2007, Germany's current account surplus vis-à-vis the euro area has shrunk continuously from 4½% of GDP to 2% of GDP. As business investment in Germany is projected to pick up in 2014 and 2015, this rebalancing should continue.

The progress that these abstract figures reflect is also visible in more concrete events. For example, Ireland and Spain have exited their financial support programmes without any friction. And Portugal is planning to leave its adjustment programme in the first half of this year. All three countries recently returned to the sovereign bond markets at relatively low yields.

At the same time, stock markets in these economies have been rising for some time now. These developments underscore the progress that some peripheral euro-area countries have made in adjusting their economies.

But we should not get ahead of ourselves. Take a look at Spain which is a country of interest to you in Texas given its relevance for Mexico. Spain is in recession and has an unemployment rate in excess of 25%. Yet, it is able to tap the bond markets in the 10-year maturity range at 3.29% – not too much above the rate that the US has to pay. This is certainly a situation in which one could start looking for signs of exuberance.

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However, due to different starting points some countries are naturally more advanced in their adjustment process than others. Especially in Greece further efforts are necessary to manage the turnaround. Against this backdrop, it is a positive sign that the country has made a successful return to the bond markets. Greece raised €3 billion with a five-year bond that was oversubscribed nearly eight-fold, and had to offer less than 5% interest.

Nevertheless, there are certainly concerns that this success might tempt policy makers to become complacent – not only in Greece but in all the crisis-countries. This must not be allowed to happen.

3 The role of monetary policy

Now, what is the role of monetary policy in this process? Monetary policy certainly helped to prevent the crisis from escalating. Still, there is one thing we should be clear about: monetary policy cannot solve the underlying causes of the crisis.

Nevertheless, some observers propose an even more expansionary monetary policy. They are worried about the risk of deflation in the euro area. It is certainly true that current inflation rates are rather low. In March, they dropped again to reach a surprisingly low level. Nevertheless, we do not conduct monetary policy by consulting the rear-view mirror but by looking ahead. And looking ahead, the risk of deflation seems to be limited. And on this issue, the Bundesbank and the ECB agree.

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The argument rests on three pillars:

- First, around two-thirds of the drop in inflation is due to falling prices for energy and food. These are exogenous factors and their effects are likely to be temporary.

- Second, low inflation rates in the euro area are partly the result of necessary adjustments in the crisis-hit countries. These should also be one-off effects.

- Third, there are no signs of a self-enforcing downward spiral of prices and wages. Long-term inflation expectations are firmly anchored at a level that is in line with the ECB's definition of price stability. Private households do not seem to be postponing expenditure in expectation of a further drop in prices. There are no indications of a substantial increase in the savings rate.

Thus, while the euro area is certainly in a period of very low inflation, the risk of deflation is very limited. Nevertheless, we are watching the developments closely. And this includes the development of the exchange rate insofar as the strong euro might, at some point, influence price stability.

4 There are still some obstacles to overcome

So, even after taking into account the issue of deflation, we can still see the end of the crisis coming closer. However, we have not reached it yet. There

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may still be some obstacles that could block the way – some of them we can already see, others we cannot see.

The latter are what Frank Knight, one of the founders of the Chicago school of economics, called “unknown unknowns”. A recent example is the political crisis in Ukraine. However, while this is an example of an “unknown unknown,” it has only limited potential to prevent us from reaching the end of the tunnel. Ukraine contributes only a quarter of a percent to global economic output. Furthermore, the exposure of European banks to Ukraine is relatively small. According to data from the Bank for International Settlements it stands at about US$23 billion.

However, we have to see the crisis in Ukraine in relation to Russia, and Russia’s relevance for the world economy is larger by far. And after all, the crisis in Ukraine reminds us that geopolitical tensions do have the power to negatively affect the global economy. But this is something central banks cannot solve.

A known obstacle that could block our way, on the other hand, is the prolonged period of very low interest rates. But please do not misunderstand me: the current status of monetary policy is certainly adequate. Nevertheless, when interest rates stay very low for a very long time, we may experience unwanted side-effects.

One of these side-effects is the search for yield. Investors may eventually increase the risk of their investments to make up for the shortfall in yields caused by low interest rates. And, indeed, it seems that investors already

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began their search for yield. In corporate debt markets, for instance, valuations are already somewhat stretched. And in the global low-interest rate environment, ambitious valuations may well spread to other market segments.

In this regard, the strong recovery in the property markets of some euro-area countries should set us thinking. I think we all remember vividly what happened after the bubble in the American housing market burst in 2007.

Take the German housing market, for example. Between 2009 and 2012, prices in large cities rose by almost 25%. And, in 2013, they increased by another 8.9%. Calculations by the Bundesbank already point to overvaluations in urban areas.

Nevertheless, when looking at the German market as a whole, the situation seems less dramatic. In 2013, prices rose by an average of 4.5% – a figure that does not give too much cause for concern. Overall, prices in Germany have not yet moved away from fundamentals.

For me, warning bells would start ringing if there was a rapid increase in housing prices accompanied by a significant rise in lending. And even more warning bells would be ringing if this rise in credit was accompanied by deteriorating lending standards. Having said that, I can assure you that at this point in time I am surrounded by silence.

But it is not only bond markets and housing markets we have to look at. Stock markets are an important issue as well. In 2013, there was only one

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way for most stock markets to go and that was up. The EuroStoxx 50 increased by 18%, the FTSE 100 by 14%, the Dow Jones by 28%, and the Nikkei skyrocketed by as much as 57%.

In addition, market volatility decreased, too. In fact, we are witnessing historically low volatility rates, which is something that might have negative side-effects. As soon as monetary policy normalises, volatility is likely to increase. This is not reflected in today's volatility levels and might tempt market participants to neglect the necessity of hedging against changes in interest rates. Let me make it clear: low volatility does not stand for low risks and interest rates will rise again at some point.

So, have financial markets entered a new phase of "irrational exuberance"? Such a verdict is certainly debatable. But financial markets are at least anticipating significant further improvements in economic fundamentals and prospects. And they are anticipating that governments around the world will continue to implement the necessary reforms. These expectations create vast scope for confidence shocks.

This, in turn, interacts in an unfavourable way with another risk arising from a prolonged period of low interest rates. A prolonged period of low interest rates could set the wrong incentives. It could encourage banks to postpone necessary balance sheet adjustments. And it might induce governments to postpone necessary structural reforms and the consolidation of public finances.

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In my view, this could be the biggest threat to the recovery process. The improved outlook together with low interest rates could lead to complacency and reform fatigue. We cannot let this happen. We cannot let it happen because there is still a lot to do to put the euro area back on a solid footing and to truly bring an end to this crisis. Reform at the national level must continue and, looking to the future, reform at the European level is equally important.

5 How to bring an end to the crisis?

At the European level, the most important project is the banking union. The banking union is most certainly the biggest step since the introduction of the euro. And it is the most logical step to take. A single currency requires integrated financial markets and this includes the supervision of banks.

Consequently, one of the pillars the banking union rests upon is a Single Supervisory Mechanism – that is European bank supervision for the largest banks. Centralising supervisory powers in such a way can foster a comprehensive and unbiased view upon banks. It also enables policy action that is not held hostage by national interests. Thus, it will contribute to more effective supervision and better cross-border cooperation and coordination.

However, the banking union does not rest on one pillar alone. A second pillar is necessary to keep everything in balance. This second pillar is the Single Resolution Mechanism. European bank supervision requires European bank

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resolution – otherwise there would be an imbalance between liability and control.

In a wider sense, resolution mechanisms are essential to solve the too-big-to-fail-problem. Large banks must be able to fail without endangering the stability of the whole system. Otherwise, the government would have to step in to prevent a systemic crisis. This would create an asymmetry: If everything goes well, the bank wins. If everything goes downhill, the taxpayers lose. This creates moral hazard for banks, endangers financial stability and threatens public finances.

The Single Resolution Mechanism will address this problem. It will allow authorities to restructure or resolve banks without putting taxpayers' money at risk. In the future, whenever a bank fails, resolution costs will have to be borne first by shareholders and creditors. After that, a bank-financed resolution fund will come into play, and only as a last resort are public funds to be used and the taxpayer made to pay.

And there is even more to do before the banking union starts. One of the biggest preparatory steps is undoubtedly the Comprehensive Assessment of those banks which will fall under European supervision. This Comprehensive Assessment consists of two elements: a backward-looking Asset Quality Review and a forward-looking stress test.

The objective of the Asset Quality Review is to uncover legacy assets in banks' balance sheets that were accumulated while the banks were under

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national supervision. The objective of the stress test is to assess how resilient banks are to stress scenarios.

Any capital shortfalls revealed by the Comprehensive Assessment have to be rectified before the banking union starts. Ideally, this would primarily involve private funds. If private funds should not be available and the bank has a sustainable business model, the respective government could step in. Ultimately, it is a question of who is responsible for past failings in banking supervision – and that is the individual member states.

The Comprehensive Assessment will allow the banking union to start with a clean slate. At the same time, it will support the necessary deleveraging of European banks. Balance sheets will eventually be "cleaned up" and any doubts regarding their quality will be removed. This will improve banks' capacity to lend to the real economy and thus support economic growth. Against this backdrop, it is crucial that the Comprehensive Assessment is conducted in a tough and thorough manner.

Nevertheless, to ensure that the real economy is properly financed we might have to consider additional options. An important step would be to revive the market for securitisation. Looking at Europe, this is of particular importance as corporate funding in Europe is much more dependent on bank credit than in the US. Meanwhile, European Asset Backed Securities (ABS) had a much better track-record during the crisis than their US counterparts: according to a recent study by the ECB and the Bank of England, the default rate for European ABS from mid-2007 to the third quarter of 2013 was 1.5%. This

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compares to 18.4% in the US. It is crucial to make securitised products attractive to investors without exerting negative effects on financial stability.

6 Conclusion

Ladies and gentlemen, I have covered a lot of ground in my speech today. Nonetheless, the central message is straightforward. The situation in the euro area is improving and the end of the crisis is coming closer. However, there is no time for complacency. Risks remain, among them reform fatigue and the side-effects of low interest rates. Thus, we must continue our efforts to put the euro area back on a sound footing.

Recently, ECB president Mario Draghi said that 2012 and 2013 were years of stabilisation for the euro area and that 2014 and 2015 may be years of recovery. If we continue down the path of reform, his expectation will prove correct.

But as I said at the beginning, the world has become closely interconnected and so, too, have risks and problems. The prolonged period of low interest rates is as much a global problem as it is a European one.

And one thing is certain: interest rates will rise again at some point. However, managing this turnaround will prove a formidable challenge. The recent turbulence in emerging markets made this very clear.

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But in the end, it was domestic problems and a lack of progress in reforms that made some emerging markets vulnerable. To restore investors' confidence, they should address domestic vulnerabilities. This might also help to bring down the exchange rate of the euro, as part of its increase was due to capital being reallocated from emerging markets to the euro area.

Although the turbulence in emerging markets does not have the potential to derail the global recovery it shows how sensitive markets are at the moment. There is still considerable scope for negative confidence shocks.

Returning to economic prosperity and financial stability requires policy-makers with a stability-oriented mind set – something I do not have to emphasise here at the "Bundesbank of the United States". It also calls for mutual understanding and trustful cooperation – qualities that are promoted by institutions such as the American Council on Germany.

I am confident that we will eventually be able to leave the times of downs, busts and turmoil behind us. And that we will finally bring an end to this seemingly endless crisis.

Thank you very much.

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