

*Embargo: Thursday, 17 October 2013, 4pm EDT*

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

The yin and yang of resolving the European sovereign debt crisis

Speech at the Peterson Institute  
in Washington DC  
Thursday, 17 October 2013

## Content

<b>1</b>	<b>INTRODUCTION .....</b>	<b>2</b>
<b>2</b>	<b>THE FAULT LINE: EQUITY VERSUS EFFICIENCY .....</b>	<b>4</b>
<b>3</b>	<b>THE CASE OF CURRENT ACCOUNT IMBALANCES .....</b>	<b>5</b>
3.1	THE PROBLEM .....	5
3.2	ONE SUGGESTION, TWO OBJECTIONS .....	6
3.3	ADJUSTMENT IS UNDER WAY .....	8
<b>4</b>	<b>THE CASE OF EUROBONDS .....</b>	<b>10</b>
4.1	THE PROBLEM .....	10
4.2	EUROBONDS WOULD AGGRAVATE THE PROBLEM.....	10
4.3	OTHER WAYS FORWARD .....	11
<b>5</b>	<b>CONCLUSION.....</b>	<b>13</b>

## 1 Introduction

Ladies and gentlemen

Thank you for having me here today. It is a great honour to speak at an institution as distinguished as the Peterson Institute. For more than 30 years now, the institute has provided essential analytical input for the work of policymakers around the world.

And when I say policymakers, I explicitly include central banks, as the institute's President, Adam Posen, has intimate knowledge of our trials and tribu-

lations. He served on the Bank of England's Monetary Policy Committee and has worked with many other central banks including the Bundesbank. He is therefore in a unique position to provide analysis and advice to central bankers such as myself.

Such advice is especially valuable in turbulent times such as these. Looking back, we see a crisis that has spanned more than six years. It began with turbulence on the US housing market, followed by a global financial crisis, a global recession and a sovereign debt crisis in the euro area. It is this last episode I would like to focus on in my speech.

Mark Twain once said: "A man who carries a cat by the tail learns something he can learn in no other way". Applied to the euro area, it seems that we have had the cat by its tail more often than not over the past three years. And as Mark Twain predicted, we have learnt a lot.

We have learnt a lot about the inner workings of the European monetary union – both economically and politically. True, everybody looks at the crisis from a slightly different angle but it seems that most of us have learnt the same lessons. At least in terms of the causes of the crisis, most of us seem to have made the same diagnosis.

According to this diagnosis, the main causes of the crisis can be found at the national and at the European level. At the national level, there was high public debt and a lack of competitiveness in those countries that are now at the centre of the crisis. At the European level, there were weaknesses in the institutional framework of monetary union.

But if most observers agree on the diagnosis of the crisis, why can't they agree on the appropriate therapy? Why is such a vast array of cures proposed? In my speech, I would like to offer an explanation for this puzzle and apply it to two of the ongoing debates on how to resolve the crisis.

## **2 The fault line: equity versus efficiency**

My starting point is one of the classic fault lines in economic theory: the fault line between equity and efficiency. Equity is mostly about redistributing resources among members of society; efficiency is mostly about allocating resources to their most productive use. Together, equity and efficiency are the yin and yang of economics.

And as in Chinese philosophy, the economic versions of yin and yang are not opposing forces but interrelated concepts. In the end, it is not a matter of "either/or" but a matter of degree. And this is at the core of the debate on how to resolve the sovereign debt crisis. Some analysts tend more towards equity or, more specifically, towards burden sharing. Other analysts tend more towards efficiency, that is, towards setting the right incentives to ensure a stable monetary union in the future.

This tug of war between burden sharing and efficiency defines nearly all debates on how to resolve the European sovereign debt crisis. It is present in the debate on how the rescue mechanisms should be constructed; it is present in the debate on a banking union, it is present in the debate on a fiscal

union, in the debate on monetary policy, in the debate on how to rebalance current accounts and in the debate on the introduction of Eurobonds.

In order to illustrate my point, I would like to address the last two issues. Let us begin with the debate on how to rebalance current accounts in the euro area.

### **3 The case of current account imbalances**

#### **3.1 The problem**

Before the crisis, there were large imbalances in the current accounts of euro-area countries. Some countries, such as Germany, the Netherlands and Austria, ran persistent current account surpluses. Other countries, such as Greece, Ireland and Spain, ran persistent current account deficits.

In principle, current account surpluses or deficits are not a problem in themselves. However, those we observed prior to the crisis were an expression of underlying barriers to sustainable growth. At the same time, they added an element of instability to monetary union. Hence the need to “rebalance Europe”.

One channel through which unsustainable current account positions can be rebalanced is the exchange rate. In a monetary union, however, using the

exchange rate is obviously no longer an option. The only option left is an internal adjustment through prices, wages, employment and output.

Such internal adjustment certainly places a burden on the economy of the affected country. There is consequently an intense debate as to which countries should adjust – those with a current account deficit or those with a surplus. And in essence, this debate is the debate between burden sharing and efficiency.

There are many who fear that it would be too much of a burden for the deficit countries alone to adjust. They therefore suggest that surplus countries should also adjust so that the burden can be shared.

I would like to challenge this view by raising two objections: one relating to the effectiveness of such an approach and the other relating to its consequences.

### **3.2 One suggestion, two objections**

In order to share the burden of adjustment, commentators such as Paul Krugman have suggested that surplus countries should lower their competitiveness. More specifically, they suggest that Germany should increase the wage level by more than is warranted by conditions on the German labour market.

The idea behind this is that competitiveness is relative: one country's loss is another country's gain. Thus, rather than just some countries going all the way in terms of adjusting their competitiveness, all countries should meet in the middle – those with a current account surplus should become a bit less competitive, those with a deficit should become a bit more competitive. The burden of rebalancing would be shared.

But how far would that approach take us? Well, I am afraid to say that it would probably not take us very far. To gauge the effectiveness of this approach, we ran our own estimates, and the results were rather disappointing.

We assumed an additional wage increase in Germany of 2 percentage points above what would normally be expected as the outcome of bargaining. Then we used our economic models to calculate the effect of this increase on the exports of peripheral euro-area countries.

Given the nature of trade flows within the euro area, the effect turned out to be close to nil. Only Ireland could expect a moderate rise in exports. At the same time, Germany's economy would take a hit. Depending on the model, employment would ultimately fall by as much as 1%, and output by  $\frac{3}{4}$ %. There would be no free lunch in terms of higher wages in Germany and higher exports of deficit countries.

And the notion of a free lunch takes us directly to my second objection against the burden-sharing approach. To see the argument, we have to look beyond the borders of Europe.

After all, Europe is not an island but part of a globalised world. And at the global level, we are competing with economies such as the United States and China. Now, what would happen if the euro-area countries followed the approach of meeting in the middle in terms of competitiveness? Well, ultimately the euro area as a whole would become less competitive vis-à-vis the rest of the world.

In my view, this is not the right path to follow. To succeed, Europe as a whole has to become more dynamic, more inventive and more productive. Any attempt to shield one European country from competition by lowering the competitiveness of another would be doomed to fail.

### **3.3 Adjustment is under way**

Now, what is my conclusion with regard to burden sharing and efficiency? Have I just been arguing for efficiency while rejecting the notion of sharing the burden? Well, again it is not a matter of “either/or” but a matter of degree.

True, in my view, the initial adjustment has to take place in the deficit countries. At the end, they operated an unsustainable model based on structural deficiencies. Reforming this model is the most promising approach to facilitate rebalancing. Not every deficit country needs the same structural reforms, of course, but all require some sort of adjustment.

And a number of reforms have already been undertaken. The process of rebalancing through structural reforms is therefore well under way. The current accounts of deficit countries have improved dramatically since 2008. The im-

provements range from nearly 9 percentage points of GDP in Ireland to more than 15 percentage points in Greece. According to recent estimates by the European Commission, most crisis countries will achieve a current account surplus this year.

Even more importantly, this adjustment is being accomplished not only by shrinking imports, but also by growing exports. All the crisis countries are projected to see some export growth this year, ranging from just under 1% in Portugal to about 4% in Spain.

And when the current accounts of deficit countries improve, the current accounts of surplus countries will automatically adjust. In the end, not every country can have a current account surplus. In a sense, we will consequently meet in the middle eventually.

Moreover, the burden of the initial adjustment, though not being shared in the narrow sense of the word, is at least being alleviated. What are the rescue packages other than publicly guaranteed interim loans to facilitate the adjustment? Thus, at the end, we have both yin and yang: the burden is being shared and efficiency is enhanced.

## **4 The case of Eurobonds**

### **4.1 The problem**

Let us now look at another example of the debate between burden sharing and efficiency: the discussion on the introduction of Eurobonds. Some commentators argue that Eurobonds would solve many of the euro area's problems. George Soros, for instance, made that point at the Global Economic Symposium in Germany three weeks ago.

In my view, however, Eurobonds would be another case of burden sharing that would come at the expense of efficiency and would endanger the stability of monetary union.

### **4.2 Eurobonds would aggravate the problem**

In order to understand the core of my argument, it is important to be familiar with the particular features of the European monetary union. The European monetary union is special in that it combines a single monetary policy with national fiscal policies.

The monetary policy for the 17 countries of the euro area is decided by the Governing Council of the ECB in Frankfurt. However, the fiscal policies of the 17 euro-area member states are a matter for the national policymakers – each country decides on its own government revenues and expenditures.

This imbalance of responsibilities gives individual countries an incentive to borrow – a “deficit bias” is introduced into the system. Our objective should be to counter that deficit bias to ensure a stable monetary union. This can only be achieved by realigning responsibilities – liability and control have to be in balance.

Would Eurobonds contribute to this objective? Granted, Eurobonds would offer temporary relief to heavily indebted member states of the euro area. But eventually they would distort the already lopsided balance between liability and control even further. While spending decisions would essentially remain a national prerogative, liability would become truly European. Incentives to incur further debt would thus be strengthened, not weakened.

#### **4.3 Other ways forward**

If we really want to realign liability and control to stabilise monetary union, we have two options. The first option would be to match European liability with European control. Only then would incentives be aligned sufficiently, as the IMF pointed out in a recent report.

This would amount to what is known as a fiscal union. Creating a fiscal union, however, would depend on the countries of the euro area transferring national sovereignty to the European level – for example, by giving the European level the right to intervene in the case of unsound public finances. In such a set-up, Eurobonds could indeed be a logical next step.

However, giving up sovereignty in this way would represent a radical change and require wide-ranging legislative changes nationally and at the European level. Such changes would need the support not only of policymakers but also of the general public. And, on this point, we should be realistic. There is no willingness to do that at present – not in Germany or in any other country of the euro area. Thus, a fiscal union is a long way off.

For the time being, that leaves us with the second option: implementing both liability and control at the national level. This would mean strengthening the original Maastricht framework, creating a “Maastricht 2.0”. Among other things, that would require strengthening the rules on borrowing – not only does the Stability and Growth Pact need teeth, it also has to be able to bite. The rules have since been tightened – now they have to be applied and compliance has to be ensured.

Let me mention something as an important side note at this point: European integration is certainly making progress. On Tuesday this week the EU finance ministers formally adopted the Single Supervisory Mechanism, which will be a central pillar of the envisaged European banking union. Thus, a major step has been taken in improving the framework of monetary union.

Now, what is my conclusion in this particular case of burden sharing versus efficiency? Well, the Bundesbank’s position has always been clear and consistent. Sound incentives are indispensable for countering the biases inherent in the euro area’s architecture.

Some burden sharing is necessary, and it is being implemented through the rescue mechanisms that grant financial assistance. But if burdens are shared in a manner that distorts incentives even further, no lasting resolution of the crisis will be possible. Introducing Eurobonds would shift the balance closer to burden sharing and further from efficiency. In the long run, this would destabilise the whole monetary union and harm all of us.

## **5 Conclusion**

Ladies and gentlemen, we all see the same crisis and we all share the same explanations for it – more or less. Nevertheless, the proposed solutions seem to be rather different from each other. In my speech, I have argued that most of these differences can be traced back to the tug of war between sharing the burden and setting the right incentives, in other words between equity and efficiency.

I have also argued that these two concepts are similar to the yin and yang in Chinese philosophy: they are not mutually exclusive but complement each other. The debate is therefore ultimately not a question of “either/or” but of the right degree.

Solidarity and burden sharing are important values in European integration, especially in a crisis. But European integration is also about building a stable future – and this requires efficient structures. We thus have to strike a delicate balance between these two concepts.

Nevertheless, in the end, both sides of the debate are not that far away from each other. And most importantly, we all share the same objective: a stable monetary union. Thus, to return to Mark Twain, let us stop carrying the cat by its tail and grab it by the neck instead.

Thank you.

\* \* \*