

“Debt crisis – days of buying time are over”

Andreas Schmitz

President of the
Association of German Banks, Berlin,
and Chairman of the Management Board,
HSBC Trinkaus & Burkhardt AG, Düsseldorf

Press conference following the
meeting of the Board of Directors
of the Association of German Banks

Frankfurt am Main, 21 November 2011

Translation - not checked against delivery

Ladies and gentlemen,

To say that the private banks in Germany have experienced quieter times than the present would probably be the understatement of the year. For what the financial sector, but also crisis-plagued policymakers, face in the way of challenges day after day at the moment makes life the exact opposite of quiet. Dealing with the European sovereign debt crisis is still something of a full-time job; we are still somewhere halfway between urgent crisis management and setting the course for a better, i.e. fiscally sounder, future. And we still don't know exactly what is going to happen in Greece, Italy and the other troubled eurozone countries.

At the same time, the regulatory machinery for banks continues to move forward, and banks themselves are doing a lot to hold their own in a difficult competitive environment, but also in a complicated climate of public opinion. Plenty of material for a press conference; plenty of talking points. I will now be looking briefly at a number of different points, though the main focus of my remarks will be on the sovereign debt crisis.

I. The sovereign debt crisis

During the past two years, ladies and gentlemen, we have seen the bankruptcy of a eurozone country, initially only an abstract possibility, become a real-life scenario. The attempts to buy time with gigantic bail-out packages ultimately failed to prevent a debt haircut in Greece's case. The risk of contagion remains high, so that even after the wide-ranging decisions taken at the EU debt summit on 26 October an end to the crisis is still not yet in sight. Quite the contrary – less than a fortnight after the Brussels agreement, Italy became the first G7 country in 40 years to be placed under International Monetary Fund supervision.

This demonstrates not only what a disastrous legacy a government reluctant to implement reforms and otherwise unwilling to act can leave behind; it also shows that a crisis of this magnitude cannot simply be resolved by adopting rescue mechanisms, however clever these may be. In Europe, it ought now to be clear to everyone that the days of buying time are over. Italy is, on the one hand, too big to fail, but, on the other hand, it is also too big to be rescued by the rest of the eurozone. It is therefore vital that under the new government the country is strong and resolute enough to also actually implement the unavoidable structural reforms.

A new era: we need a different Europe

This debt crisis means that the process of European unification has undoubtedly reached a crossroads. Only more political integration – within the limits of what is realistic – will ensure the eurozone’s survival in the long term. The EU treaties consequently need to be altered, something which in a period of widespread “euro fatigue” calls for a high degree of political leadership – particularly as what is involved is nothing less than a partial transfer of fiscal sovereignty to Brussels. So close coordination of fiscal and economic policy will, on its own, not be enough. What we also need is a system of automatic sanctions for breaches of budgetary discipline, a debt brake anchored in national constitutions, and a kind of “austerity commissioner” to punish fiscal misconduct.

The Europe after this crisis will – and must – be different from the Europe before the crisis. And the EU and its institutions need to quickly regain the level of reliability and trust for which they have otherwise been known so far in Europe and the rest of the world. However, this is likely to be difficult if we don’t stop chipping away at the foundations of monetary union – particularly the remit given to the European Central Bank, which is geared plainly to safeguarding price stability. Monetary union will only become a successful, long-term ‘stability union’ if economic, fiscal and monetary policymakers perform the tasks they have been assigned. In other words, the increasingly vociferous calls for the ECB to permanently fund national budgets are tantamount to a direct attack on the idea of monetary union as a stability union. So I expressly welcome it that the Bundesbank and, in particular, its President, Jens Weidmann, have rejected such calls. At the same time, it is also clear that fighting off potential fire-raisers and directly fighting a fire are two different kettles of fish. This means that the ECB should by all means play a role in urgent crisis management.

The future of public finance

The current sovereign debt crisis will mark a watershed – indeed, more than that, the beginning of a new political era – in another respect as well. Because for most countries the days of being able to pile up more and more debt relatively easily and cheaply are likely to be over for good. The fact that the bankruptcy of a eurozone country is no longer the stuff of trashy novels is a warning sign: public debt in numerous countries has now reached a critical level, one where many creditors have doubts about whether it is still actually manageable or whether a new Greek-style failure is imminent.

So in future it will no longer be standard procedure for countries to finance their budgets via the capital markets. In other words, market behaviour will change; we are at a turning point in how we assess public budgets and sovereign debt.

As a direct consequence, the interest rate that countries have to pay on their bonds is likely to be higher than in the past and, in particular, to fluctuate more sharply upwards if political decisions are taken that could further inflate public debt. What high interest rates mean for countries that are already carrying a heavy debt load has been made painfully clear to us over the past few months. So returning to a policy of sound public finances is essential.

Banks, too, will no longer automatically hold government bonds on their books in future. This doesn't mean that they won't do so, but it is a decision that will depend more than ever before on whether debtor countries can convince their creditors that they have a solid, long-term fiscal and economic policy.

I make a point of saying this, given the fierce public criticism voiced in some cases of banks' investment in European government bonds so far. This criticism usually culminates in the charge that banks just wanted to make an easy killing without any risk and, when it became clear that some countries were heading for bankruptcy, they then relied on the state to bail them out again. Just how irrational this accusation is, is shown by the fact that precisely those banks which unloaded their southern European government bonds – without pocketing any kind of speculative profits in the process, by the way – were criticised as irresponsible.

The fact is that investing in government bonds has never been a particularly lucrative line of business for banks. At the same time, the resulting income was indeed regarded as relatively safe, the bonds served as a liquidity management tool, and there was no need to set aside capital. Which makes one thing clear: banks have been a major source of public finance so far particularly because this was what countries expressly wanted. The zero weighting for government bonds, a basic regulatory condition created deliberately by policymakers for this purpose, undoubtedly set wrong incentives and should now be gradually replaced.

At least when it comes to bonds issued by countries with both a high level of public debt and a heavy foreign deficit, the business of the past, i.e. banks

buying government bonds, will not survive in its present form. The experience made during the last few months – a debt haircut involving private creditors included – has been too disillusioning to allow anything else. This means that many finance ministers could lose a safe investor to some extent and may, as a result of the crisis, have to look around for new lenders. However, who these lenders are to be if banks cut back their activities in future and are quite evidently no longer wanted as creditors is an intriguing question.

In the Middle Ages, French kings sometimes got rid of their debts in seemingly hopeless situations by simply having their creditors executed. Thankfully, this is no longer a solution today. But cursing the financial markets and warning against countries being held hostage by them is no solution either. Let me just say this: the impatience of the financial markets is due to creditors' legitimate concern about their money. And if policymakers feel that the financial markets are dictating what they do, this is also because they have put themselves in a tight spot by making wrong decisions in the past. Besides, a certain amount of pressure for action applied by the markets and creditors is likely to quite helpful. Without this pressure, a government like the last one in Italy would probably still be in power and still delaying the necessary reforms.

Change in mindset needed

This is a sovereign debt crisis and not a banking crisis. True, the deficits of recent years are in part directly linked to the effects of the financial crisis and the subsequent deep recession. But the problem of steadily rising government debt is much older, more stubborn and more deeply rooted.

So it won't be enough to cut spending here and there and pin our hopes on a flourishing economy. What we need now is nothing less than a change in mindset – in all industrialised countries. For a long time the OECD states paid too little attention to the fact that, imperceptibly at first and then ever more obviously, the necessary social safety net was being financed by new debt and not from annual revenue. All the signs are, however, that the sovereign debt crisis has for the time being put an end to the era of the debt-funded welfare state. This also applies very much to the US, incidentally, even if generous social policies are not primarily to blame for its enormous debt mountain. Today, government debt in the US is at least as serious a problem as it is in Europe. According to IMF forecasts, America's public debt will exceed 100% of GDP as early as 2012.

Strengthening competitiveness

If borrowing is no longer a viable option and we don't want to risk social divides becoming deeper, thus undermining the legitimacy of our economic order, we're basically left with just one choice – to set a course for a future where prosperity is genuinely earned in a globally competitive environment and not bought on tick. This message is addressed above all to those countries whose economies have for years lacked competitiveness and are increasingly losing ground even within Europe. There's nothing arcane, moreover, about the structural reforms that now need to be set in motion; the answer is often perfectly obvious. Implementation may be painful, but the world will not wait until Europe gets around to taking action.

The German economy is efficient, ladies and gentlemen, and this means our public finances are in better shape than in countries which for years have seen one current account deficit after another. So Germany has every chance of consolidating its public financing successfully and sustainably. Nevertheless, the prospect of essentially having to establish social equity without running up new debt is a highly demanding one. Despite successful economic reforms in the past and despite the excellent financial and economic data compared to the situation in other European countries, we must not waver in our efforts to strengthen our competitiveness and cut our debt.

II. Regulation

Doing one thing doesn't necessarily mean – and in this case must not mean – neglecting another. In other words, the sovereign debt crisis must be confronted and resolved. At the same time, however, there should be no let-up in efforts to make the financial system more stable and less prone to crises. We've already taken a big step forward towards achieving this – as a result of the banks' own efforts but also as a result of already implemented or agreed regulatory action. Regulation, ladies and gentlemen, isn't something banks reject out of hand. Our industry has made too many mistakes, whose consequences have been far too costly to even dream of presenting "business as usual" as an alternative. This is why the banks began long ago to rectify past shortcomings. And this is why we also need good, meaning effective, regulation of the financial sector.

Regulate well, not excessively

But I'd like to make two points in this context. First, measures should not be formulated one way today, another way tomorrow and differently again the day after. The "flash stress test" that the EBA suddenly pulled out of the hat and which requires big banks to have far higher Tier 1 capital ratios by mid-2012 than those previously envisaged is one example of how not to do things. It may well make good sense in principle to consider the likelihood of default on European government bonds when testing the stability of European banks. But it doesn't exactly help to build up trust if completely new requirements are conjured up more or less overnight, triggering a totally unnecessary debate on a possible mandatory capitalisation of German banks.

Second, regulation should be designed in such a way that banks are in a position to meet the associated requirements. The plain and simple truth is that banks can only build up capital if they are not prevented from doing so in other ways. That they managed to increase their capital ratios over the last two or three years – even before negotiations on Basel III were complete and made it mandatory – doesn't mean it was, or will be, an easy task. Regulating to excess in one area will inevitably cause problems in another.

Good regulation undoubtedly has its price. But good regulation should also ensure that the cumulative effect it generates doesn't put a stranglehold on banks. We've almost reached that point now: the air supply has already become thin. What is now required is prudent regulation by policymakers. I doubt, in this connection, whether it makes good sense for a project like the financial transactions tax to be pushed through come what may, and possibly in selected euro states only. The benefits of the tax, even if it were introduced throughout the eurozone, are highly questionable, yet the risk of damage caused by evasive action and weaker growth cannot be dismissed. Another thing to bear in mind is that regulation needs to target the real risks. That these emanate to a significant extent from the shadow banking system, where the regulation process is, at best, in its infancy, is far from optimal.

III. Banks and society

Ladies and gentlemen, I'd like to conclude with a few words on the extremely difficult atmosphere banks are currently operating in. The renewed criticism levelled at us as a result of the sovereign debt crisis is not just something we

take seriously – we've also taken it to heart. Some of the accusations are undoubtedly groundless, others at the very least lack balance. I nevertheless understand that many citizens feel uneasy when banks, given the financial crisis of 2008 that they helped to create, are once again mentioned in the same breath as "rescue package" or "stabilisation fund". And the fact that even well informed people don't understand a lot of what banks do or what goes on in the financial markets is hardly something they can be blamed for. For these reasons, we see it as our responsibility to seek dialogue with the public – and this most certainly includes movements such as "Occupy" – and to engage in conversation wherever there is readiness to listen.

The private banks in Germany are part of this society, ladies and gentlemen, and, what's more, the most important partner of German businesses. This is demonstrated by a recent survey, which found that the private banks rank higher – sometimes significantly higher – than the other sectors of the banking industry when it comes to corporate lending, export finance and partnerships for renewable energy. Almost 80 per cent of German exports are financed by our member banks. This shows that the private banks still have their feet on the ground. They and their workforce of almost 180,000 are an indispensable part of the German economy. This brings me to the end of my remarks, ladies and gentlemen, and I would like to thank you for your attention.