Axel A Weber: What role is economic and monetary union playing in mitigating the impact of the global crisis?

Dinner speech by Professor Axel A Weber, President of the Deutsche Bundesbank, at the 964th Wilton Park Conference, Eltville-Erbach, 17 March 2009.

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1 Introduction

Dear Mr Lamont, ladies and gentlemen

It is a very great pleasure for me to welcome you all to this conference dinner in Eltville.

I hope that you are enjoying your stay at the Bundesbank's training centre. Eltville is a nice place to be: it has a picturesque location in the heart of the Rheingau region, which is well known for its mild climate throughout the year.

Eltville is called the town of wine, sparkling wine and roses. As regards the quality of the local wines, you will have the opportunity to taste them, especially here tonight in the Baron Knyphausen wine estate. As for the bloom of roses, you have certainly come too early. Times are not rosy in general, however.

Indeed, we are currently experiencing a global economic crisis. What originally began as a crisis on financial markets has spilled over to the real economy in industrialised, emerging and developing countries.

According to World Bank estimates, the global economy is likely to shrink this year for the first time since the Second World War. For the euro area, ECB experts expect GDP to decline by 2.2 % to 3.2 % this year. Taking into account the fact that non-euro area EU economies are also expected to perform more or less poorly, the topic of this conference "How can growth in the European Union be restored?" is indeed a crucial one.

In my remarks, I would like to focus on the following questions. What is the impact of the financial crisis on European monetary integration and what role has EMU and, in particular, the Eurosystem been playing in mitigating the impact of the financial crisis?

Let me start with the second question.

2 What role has the Eurosystem been playing in mitigating the financial crisis?

The central banks of the Eurosystem are dealing in many ways with the effects of the financial crisis. They are participating in relevant international fora and organisations and are, albeit to a varying extent, involved in banking supervision issues at the national level, including rescue action for troubled financial institutions. This evening I would like to concentrate on two other major issues: liquidity operations and monetary policy.

The subprime crisis in the US has often been referred to as the trigger for the financial crisis, but the root causes of the current crisis lie deeper. In a nutshell, we experienced an enormous credit boom during a period before, characterised by an extreme undervaluation of risk. This was supported by favourable macro-economic conditions – not least, interest rates that were too low for too long.

Excessive risk-taking was further encouraged by a lack of transparency and market failures in the process of credit risk transfer. Pro-cyclicality in the institutional design of financial markets, such as capital adequacy rules, accounting rules and remuneration schemes, also encouraged extreme leverage in the financial system while they are now contributing to a fatal deleveraging. When the famous "wake-up call" occurred, financial markets panicked and suffered a massive liquidity shock.

From the onset of the crisis, in August 2007, the Eurosystem began supporting the financial system, especially in terms of frontloading liquidity provision during minimum reserve periods and extending the average duration of its open market operations. These measures helped financial institutions through a period of unprecedented high volatility on inter-bank markets.

However, after the collapse of Lehman Brothers and the ensuing “earthquake” of September 2008, the Eurosystem had to extend its liquidity operations vigorously in order to keep euro area money markets alive.

Several measures were taken in order to calm the markets, of which the temporary guarantee of full allotment at fixed rates has been the most important. Furthermore, we have temporarily widened the scope of eligible collateral and we have stepped up providing relief to euro area financial institutions via currency swap arrangements with liquidity in foreign currencies.

Taken all together, these measures have resulted in the Eurosystem assuming the role of the central counterparty in the money market. While this has saved euro area financial markets from breakdown, it is obvious that playing this role is something that cannot and should not last forever.

However, the other post-Lehman measures are staying in place for the time being owing to the ongoing vulnerability of the money markets. In particular, the Governing Council of the ECB has declared that it will continue the fixed rate tender procedures with full allotment for as long as needed and, in any case, beyond the end of 2009.

While volatility in euro money markets is still very elevated, we can observe that some relevant risk- spread indicators are trending back to – let us call it – “Pre-Lehman” levels. Expecting “pre-crisis”-levels to make a comeback – the time when risk was significantly underestimated – is neither realistic nor desirable.

However, sustainable relaxation in the inter-bank money markets requires a sustainable return of confidence in the financial markets. In order to achieve this aim, it is necessary that the process of restoring banks’ balance sheets continues, supported by public stabilisation funds.

3 EMU and the financial crisis

For European monetary union, the financial crisis is certainly posing the greatest challenge in its history.

When we recently celebrated the tenth anniversary of the single currency’s inception, it was often stated that the first ten years of the euro were a success story with regard to price stability, trade and financial integration in Europe. However, it was also stated that the years ahead are likely to become even more challenging.

One could say that EMU is reaching puberty – if you have children, you will know what I mean.

Nonetheless, the value of monetary union has never been greater than during the financial crisis. Try to imagine what would have happened without the single currency!

Probably, foreign exchange markets within the single market would have been driven by speculative activities. Think of what happened in the early 1990s. Currency fluctuations would aggravate both the financial crisis and real economic tensions – and do not forget the political turbulence implied by such currency tensions.

It has been clear from the beginning of monetary union that there has been a greater emphasis on the responsibility for fiscal policies, wage policies and structural policies, which remains at the national level. In a nutshell, monetary union requires flexible labour markets and sound public finances – this holds true especially during times of crisis. With regard to fiscal policy, respecting the provisions of the Stability and Growth pact is of the essence. What is needed is a credible and strong commitment to reducing excessive deficits and to returning to the path of consolidation.

Rising CDS premia on sovereign bonds have induced speculation about potential defaults on the part of EMU countries. Any concerns in this regard are unfounded and only purely hypothetical.

While it is in general welcome that financial markets punish unsustainable public finances, it has to be acknowledged that even euro area member states with high yield spreads are currently facing favourable refinancing conditions given the unprecedented low interest rates.

It should be emphasised that the "no-bail-out" rule, as stipulated in the EC Treaty, is an indispensable instrument for preventing moral hazard behaviour by the member states. With that in mind, issuing blank cheques would definitely be the wrong course of action.

Yet, EMU is our common destiny. If any kind of help for a member state were necessary in the improbable case of an extreme emergency, the clear conditionality of such support would be essential in order to comply with the Treaty.

As regards recent speculation about a potential EMU split-off, I am convinced that – apart from the absence of any legal framework for this – it would make no sense economically for any member state to use an exit option. This is due to the huge costs that such an exit would entail.

Metaphorically speaking, as ECB President Trichet correctly put it, "in stormy seas it's better to be on a large ship than in a small boat". Having said that, it is no wonder that many of those in small boats are currently seeking to dock to the large ship.

To achieve this, it has never been more evident than now that full compliance with the convergence criteria of the Maastricht Treaty is absolutely indispensable with respect to any EMU enlargement.

4 Concluding remarks

Ladies and gentlemen, let me conclude.

Central banks around the world are trying to mitigate the negative impact of the financial crisis in cooperation with other national and international institutions. With regard to the Eurosystem, it should have become clear that we will do all that is necessary and possible to restore financial and economic stability in the euro area.

Ten years after its introduction, the euro is facing its greatest challenge. I firmly believe, however, that it will do fine.

Thank you for attention.