Jens Weidmann: Global economic outlook – what is the best policy mix?

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Economic Club of New York, New York, 23 April 2012.

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1. Introduction

Ladies and Gentlemen

George Bernard Shaw is said to have made an interesting remark about apples – "If you have an apple and I have an apple and we exchange these apples then you and I will still each have one apple. But if you have an idea and I have an idea and we exchange these ideas, then each of us will have two ideas."

I think those words perfectly encapsulate the intention of the Economic Club of New York and of today's event. Ideas multiply when you share them and they become better when you discuss them.

I am therefore pleased and honoured to be able to share some ideas with such a distinguished audience today. And I look forward to discussing them with you.

In a long list of speakers, I am the third Bundesbank President to speak at the Economic Club. The first was Karl Otto Pöhl in 1991, followed by Hans Tietmeyer in 1996.

Although only a few years have passed since then, the global economic landscape has completely transformed in the meantime – just think of the spread of globalisation, think of the introduction of the euro, think of the Asian crisis or the dotcom bubble. All these events and others have constantly shaped and reshaped our world.

Most recently, we have experienced a crisis that, once again, will change the world as we know it – economically, politically and intellectually. It is this new unfolding landscape that provides the backdrop to my speech.

I shall address two questions: "Where do we stand?" and "Where do we go from here?"

Of course, it is the second question that is the tricky one. In answering it, we should be aware that every small step we take now will determine where we stand in the future.

Specifically, I shall argue that measures to ward off immediate risks to the recovery are closely interconnected with efforts to overcome the causes of the crisis. They are interconnected much more closely and vitally than proponents of more forceful stabilisation efforts usually assume.

But, first, let us see where we stand at the present juncture.

2. Where do we stand?

When we look back from where we are standing right now, we see a crisis that has left deep scars.

The International Labour Organisation estimates that up to 56 million people lost their jobs in the wake of the crisis. This number equals the combined populations of California and the state of New York.

Or look at government debt: Between 2007 and 2011, gross government debt as a share of GDP increased by more than 20 percentage points in the euro area and by about 35 percentage points in the United States.

I think we all agree that the crisis was unprecedented in scale and scope. And the first thing to do was to prevent the recession turning into a depression. Thanks to the efforts of policymakers and central banks across the globe, this has been achieved.

Following a slight setback in 2011, the world economy now seems to be recovering. In its latest World Economic Outlook, the IMF confirms that global prospects are gradually strengthening and that the threat of sharp slowdown has receded.

Looking ahead, the IMF projects global growth to reach 3.5% in 2012 and 4.1% in 2013. For the same years, inflation in advanced economies is expected to reach 1.9% and 1.7%.

Basically, I share the IMF's view. However, we all are aware that these estimates have to be taken with a grain of salt – probably a large one. Being a central banker, I am not quite as calm about inflation. Taking into account rising energy prices and robust core inflation, prices could rise faster than the IMF expects.

We have to be careful that inflation expectations remain well anchored and consistent with price stability. Expectations getting out of line might very well turn out to be a non-linear process. If this were to happen, it would be difficult and expensive to rein in expectations again.

Even though the outlook for growth has improved over the past months, some risks remain – the European sovereign debt crisis being one of them. And this seems to be the one risk that is weighing most heavily on peoples' minds – not just in Europe but here in the United States, too.

The euro-area member states have responded by committing to undertake ambitious reforms and by substantially enlarging their firewalls. This notwithstanding, the sovereign debt crisis has not yet been resolved. The renewed tensions over the past two weeks are a case in point. Thus, we have to keep moving, but each step we take has to be considered very carefully. As I have already said: each small step we take now will determine where we stand in the future.

3. Where do we go from here?

Eventually, three things will have to happen in the euro area. First, structural reforms have to be implemented so that countries such as Greece, Portugal and Spain become more competitive. Second, public debt has to be reduced – a challenge that is not confined to the euro area. Third, the institutional framework of monetary union has to be strengthened or overhauled, and we need more clarity about which direction monetary union is going to take. I think we all agree on this – including the IMF in its latest World Economic Outlook.

However, there is much less agreement on the correct timing. Since the crisis began, the imperatives I have just mentioned have tended to be obscured by short-term considerations. And surprisingly, this tendency seems to be becoming stronger now that the world economy is getting back on track.

This view is reflected by something Lawrence Summers wrote in the *Financial Times* about four weeks ago. Referring to the US, he said that "… the most serious risk to recovery over the next few years […] is that policy will shift too quickly away from its emphasis on maintaining adequate demand, towards a concern with traditional fiscal and monetary prudence."

It is in this spirit that some observers are pushing for policies that eventually boil down to "more of the same": firewalls and ex ante risk sharing in the euro area should be extended, consolidation of public debt should be postponed or, at least, stretched over time, and monetary policy should play an even bigger role in crisis management.

I explicitly do not wish to deny the necessity of containing the crisis. But all that can be gained is the time to address the root problems. The proposed measures would buy us time, but they would not buy us a lasting solution.

And five years after the bursting of the subprime bubble and three years after the turmoil in the wake of the Lehman insolvency, we have to ask ourselves: Where will it take us if we apply these measures over and over again – measures which are obviously geared towards alleviating the symptoms of the crisis but which fail to address its underlying causes?

In my view, this would take us nowhere. There are two reasons for this. First, the longer such a strategy is applied, the harder it becomes to change track. More and more people will realise this and they will start to lose confidence. They will lose confidence in policymakers' ability to bring about a lasting solution to our problems. And we should bear in mind that the crisis is primarily a crisis of confidence: of confidence in the sustainability of public finances, in competitiveness and, to some extent, in the workings of EMU.

But there is a second reason why the "more of the same" will not take us anywhere. The analgesic we administer comes with side effects. And the longer we apply it, the greater these side effects will be, and they will come back to haunt us in the future.

In the end, it is just not possible to separate the short and the long term. You will be tomorrow what you do today.

With these two caveats in mind, let us take a closer look at the suggested policy mix. For the sake of brevity, I shall focus on monetary and fiscal policies.

3.1 An even bigger role for monetary policy?

To contain the crisis, the EMU member states have built a wall of money that recently reached the staggering height of 700 billion euros. As I have already said, ring-fencing is certainly necessary, but again: it is not a lasting solution. And it is not the sky that's the limit – the limits are financial and political.

In the face of such limits, the Eurosystem is now seen as the "last man standing". Consequently, some observers are demanding that it play an even bigger role in crisis management. More specifically, such demands include lower interest rates, more liquidity and larger purchases of assets.

But does the assumption on which these demands are based hold true when we take a closer look at it? In the end, monetary policy is not a panacea and central bank "firepower" is not unlimited, especially not in monetary union.

True, this crisis is exceptional in scale and scope, and extraordinary times do call for extraordinary measures. But the central banks of the Eurosystem have already done a lot to contain crisis. Now we have to make sure that by solving one crisis, we are not preparing the ground for the next one.

Take, for example, the side effects of low interest rates. Research has found that risk-taking becomes more aggressive when central banks apply unconditional monetary accommodation in order to counter a correction of financial exaggeration, especially if monetary policy does not react symmetrically to the build-up of financial imbalances. In the end, putting too much weight on countering immediate risks to financial stability will create even greater risks to financial stability and price stability in the future.

The Eurosystem has applied a number of unconventional measures to maintain financial stability. These measures helped to prevent an escalation of the financial turmoil and constitute a virtually unlimited supply of liquidity to banks. But monetary policy cannot substitute for other policies and must not compensate for policy inaction in other areas.

If the Eurosystem funds banks that are not financially sound, and does so against inadequate collateral, it redistributes risks among national taxpayers. Such implicit transfers are beyond

the mandate of the euro area's central banks. Rescuing banks using taxpayers' money is something that should only be decided by national parliaments.

Otherwise, monetary policy would nurture the deficit bias that is inherent to a monetary union of sovereign states. In this regard, the situation of the Eurosystem is fundamentally different from that of the Federal Reserve or that of the Bank of England.

Moreover, extensive and protracted funding of banks by the Eurosystem replaces or displaces private investors. This breeds the risk that some banks will not reform unviable business models. So far, progress in this regard has been very limited in a number of euro-area countries.

And the Eurosystem has also relieved stress in the sovereign bond market. However, we should not forget that market interest rates are an important signal for governments regarding the state of their finances and that they are an important incentive for reforms.

Of course, markets do not always get it right. They may have underestimated sovereign risks for a long time and now they are overestimating it. But past experience taught us that their signal is still the most powerful incentive we have. At any rate, I would not rely on political insight or political rules alone.

After all, monetary policy must not lose sight of its primary objective: to maintain price stability in the euro area as a whole. What does this mean? Let us say that monetary policy becomes too expansionary for Germany, for instance. If this happens, Germany has to deal with this using other, national instruments.

But by the same token, we could say this: even if we are concerned about the impact on the peripheral countries, monetary policymakers must do what is necessary once upside risks for euro-area inflation increase. Delivering on its primary goal of maintaining price stability is essential for safeguarding the most precious resource a central bank can command: credibility.

To sum up: what we do in the short-term has to be consistent with what we are trying to achieve in the long-term – price stability, financial stability and sound public finances. This implies a delicate balancing act – a balancing act we shall upset if we overburden monetary policy with crisis management.

3.2 Rethinking consolidation and structural reforms?

Now, what about consolidation and structural reforms? Here, too, we have to strike the right balance between the short and the long run.

Those who propose putting off consolidation and reforms argue that embarking on ambitious consolidation efforts or far-reaching structural reforms at the present moment would place too great a burden on recovery. They do not deny the necessity of such steps over the medium term, but in the short-run they consider it more important to maintain adequate demand, avoid unsettling people and nurture the recovery.

But in the end, the current crisis is, to a large degree, a crisis of confidence. And if already-announced consolidation and reforms were to be delayed, would people not lose even more confidence in policymakers' ability to get to the root of the crisis? We can only win back confidence if we bring down excessive deficits and boost competitiveness. And it is precisely because these things are unpopular that makes it so tempting for politicians to rely instead on monetary accommodation.

It is true that consolidation, in particular, might, under normal circumstances, dampen aggregate demand and economic growth. But the question is: are these normal circumstances? It is quite obvious that everybody sees public debt as a major threat. The markets do, politicians do, and people on Main Street do.

A widespread lack of trust in public finances weighs heavily on growth: there is uncertainty regarding potential future tax increases, while funding costs are rising for private and public creditors alike. In such a situation, consolidation might inspire confidence and actually help the economy to grow.

In my view, the risks of frontloading consolidation are being exaggerated. In any case, there is little alternative. In the end, you cannot borrow your way out of debt; cut your way out is the only promising approach.

4. Conclusion

Allow me to conclude by going back to the beginning of my speech where I mentioned the benefits of sharing and discussing ideas.

I have stressed that we have to embark on reforms that make the crisis countries more competitive; that we have to reduce public debt and that we have to further improve the institutional framework of monetary union.

But the spirit of my argument was expressed succinctly some 20 years ago by Karl Otto Pöhl. In his speech at the Economic Club he said: “The true function of a central bank must be, however, to take a longer-term view.”

And after five years of crisis, the long term might catch up with us faster than we expect. We therefore have to think about the future now – and we have to act accordingly as well.

Thank you for your attention.