Jens Weidmann: 55 years for stability

Interview with Dr Jens Weidmann, President of the Deutsche Bundesbank, and Helmut Schlesinger, former Bundesbank President, published in the staff magazine of the Bundesbank on 27 July 2012.

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Mr Schlesinger, our interview is also an attempt to explain how the Bundesbank's stability culture has evolved. Independence and the objective of price stability were already enshrined in the Bundesbank Act of 1957.

Schlesinger: Actually, it was the establishment of the *Bank deutscher Länder* earlier which had helped the stability culture to develop. The money issued in 1948 was quickly put to the test: in 1950, during the Korean War. The prices of commodities and other imports shot up, and the public was in a state of major panic and unrest. Many began hoarding again; we had been going hungry just one and a half years earlier. At the time, I was involved in a study for the ifo Institute and was in contact with the Ministry of Economics. I know that experts there were already looking into the reintroduction of price freezes and ration cards for food, which we had already seen during and after the war.

What did the **Bank deutscher Länder** ***do?***

Schlesinger: It did something that seems absolutely inconceivable nowadays: it set a limit for credit expansion in order to attempt to scale back the volume of money. This enabled the *Bank deutscher Länder* to stabilise the D-Mark over the course of 1951 and restore confidence in the value of the currency. This lay the proper groundwork – for the success of the currency reform, the abolition of rationing and price controls, and the stability of the currency. This allowed the upswing to get started.

Was **BdL** ***management in agreement on the stability policy course from the beginning?***

Schlesinger: Privy Councillor Wilhelm Vocke, who was President of the Bank at the time and is regarded as the founder of the Bundesbank's reputation, was very strict. His influence on the Central Bank Council was strong and often endured only under barely audible protest. I remember that in 1956 Vocke was asked to comment before a parliamentary committee on the introduction of the index-linked pension. His only sentence was: "I believe it would be a danger to stability to introduce the index-linked pension." Coming from him, that had to suffice.

However, there were also opposing movements within the Bundesbank, such as when deciding in 1960 for or against revaluation of the D-Mark.

Schlesinger: During the 1950s, it gradually became clear that the exchange rate of DM4.20 to the US dollar set by the Allies was too favourable to Germany. We had an undervalued currency and considerable balance of payments surpluses, with implications for monetary policy: in a system of fixed exchange rates, the Bundesbank had to keep buying up foreign currency in order to keep the exchange rate stable. It was thus involuntarily creating central bank money. Ludwig Erhard, the Economics Minister, therefore wanted a revaluation ...

... against which there was considerable opposition!

Schlesinger: Along with Chancellor Konrad Adenauer, the Federal Association of German Industry and the German banks, the Bundesbank and its President, Karl Blessing, were officially opposed to a revaluation, as they feared that this would weaken the export industry. However, there were also proponents of revaluation at the Bundesbank, yet their opinions did not become public, with a few exceptions: The then-new Vice-President of the Land Central Bank of Lower Saxony, Heinrich Irmler, came out in favour of a revaluation in the Land Central Bank's annual report, which caused a major hubbub in Frankfurt. However, I would like to add one thing: over the decades, there were no further tensions within the Bank with regard to its stability orientation ...

Weidmann: … and that has been the case to this day. Despite all our various qualifications and tasks, within the Bank, there is a shared vision and a clear commitment to monetary stability. This is unique for such an institution and has also made the Bank an attractive option for people applying to work for us. The public good of maintaining price stability and thus contributing to the common good is a major incentive for many.

Mr Weidmann, how did you yourself see the Bundesbank, say, while you were at university?

Weidmann: In 1987 I was studying in France. The Banque de France was not yet independent at the time. That is when I first clearly saw the differences in outlook concerning the role of, and oversight over, the central bank. I myself had pretty much “inhaled” the Bundesbank’s role; my French student friends, however, could not possibly imagine a government institution performing a key sovereign task and still being outside parliamentary control. Two very different world views were colliding. They have continued to do so in all political debates – essentially, up to the present day.

Where can you identify this?

Weidmann: I recently gave an interview to the French daily newspaper “Le Monde”. Many readers responded to the substantive positioning, some positively, some negatively. However, some responded along the lines of “Why is he meddling in the political debate? He’s only a central bank governor, a “civil servant” who actually shouldn’t be saying anything on the matter.

It was also the crisis of the European Monetary System (EMS) in 1992 and 1993 which showed just how different ideas of the central bank’s role within Europe were in those days.

Schlesinger: German reunification meant that we were in a difficult position in 1990. The politically determined conversion rate of the East German mark caused a massive increase in the money stock to a size considerably larger than was justified by the former GDR’s potential output. In addition, wages were increased quickly, which obliterated the competitiveness of East German businesses. We had an inflation rate in excess of four per cent and needed to tighten monetary policy in Germany. We succeeded, too; however, our increase in interest rates did not sit well with some of our fellow members of the EMS. They would rather have lowered rates, but could not do so owing to their currencies’ peg to the D-Mark. The proper action would have been to adjust the central rates: in other words, realignment.

What was the reason for that not happening?

Schlesinger: The finance ministers seemed not to be listening. During the decisive negotiations, the central bankers were seated at the margins; that was the role assigned to them. Norman Lamont, the UK Chancellor of the Exchequer and chairman of the Ecofin Council, then tried to force Germany to lower its interest rates. He demanded that I personally – not the Central Bank Council – lower interest rates that following Monday. I then had to explain to him, first, that it was not possible, and second, we would not do that anyway. The following weeks saw very strong interventions against the Italian lira, the Portuguese escudo and the Spanish peseta, and in the end, also against the pound sterling. Instead of realigning, the UK dropped out of the EMS. The result was a depreciation which was twice as large as it would have been in a realignment. These were the tensions inherent in the EMS and its narrow exchange rate bands ...

... which ultimately led to the bands being enlarged to 15 per cent in August 1993.

Weidmann: I can very well remember where I was when I heard the news: in New York City. On Times Square I saw a large digital billboard with a ticker announcing the news. That was a crucial turning point for me. The way I had perceived it, the path towards European Integration had up until then always been pointing in one direction: towards greater integration. However, the tensions in the system were now patently obvious.

Schlesinger: At all events, with these bands, proposed by France upon our advice, the EMS functioned smoothly up until the introduction of the euro.

In 1990, the Bundesbank wrote that the participants in economic and monetary union would be inextricably linked to one another "come what may" and that such a union would be an "irrevocable joint and several community which, in the light of past experience, requires a more far-reaching association, in the form of a comprehensive political union, if it is to remain durable".

Weidmann: The assessment at that time merely reflected the Bank's long-held position. As early as 1963, President Karl Blessing had stated that the introduction of monetary union should be conditional on political union. The Bank's stance has not only been consistent over time but has, in fact, taken on even greater relevance in a dramatic way owing to the recent crisis in the euro area.

Political union did not feature in the Maastricht Treaty at the end of 1991.How did the Central Bank Council react to this?

Schlesinger: When I took office as President of the Deutsche Bundesbank in the summer of 1991, Chancellor Helmut Kohl was still in favour of political union. However, the decision to implement monetary union by no later than 1999 was taken just four months later. This was a clear defeat for us. There is no other way of putting it. We had assumed that the Treaty would be concluded with a definition of the entry criteria, but without a fixed date being set.

Weidmann: It is interesting that we are having a similar discussion now in connection with the banking union. Here, too, some quarters are evidently seeking a far-reaching joint solution, but without imposing stricter rules on the other policy areas that are also affected. A genuine European banking supervision can indeed form a major component of closer integration within monetary union. However, such an institutional reorganisation of banking supervision also has to be integrated – into a comprehensive reform of the supervisory regulatory framework and of the respective national scope for economic and fiscal policy. Otherwise, too great a burden will be placed on banking supervision.

What is crucial for political union is the willingness to hand over national sovereignty. Does such a willingness actually exist within the EU?

Schlesinger: This question always takes me back to the start of European unification. At that time, the main objective was quite a different one – namely, to ensure that there would never again be a war in Europe. The plan for a common European army was ultimately blocked by France, even though the loss of sovereignty involved would have been easy to implement. It is actually hard to envisage how a loss of monetary sovereignty could be achieved in the absence of a unified state.

Weidmann: Seeing how reluctant some countries are to relinquish their fiscal policy autonomy – even in return for financial assistance – it is hard to imagine political union being achieved in the foreseeable future.

Mr Schlesinger, should the Bundesbank have fought more strongly against monetary union without a political counterweight in the 1990s?

Schlesinger: All of our demands were fulfilled. But I think we all underestimated just how wide the gulf is in the mindset not only of the political class but also in terms of public opinion in the individual countries concerning the objectives of fiscal policy. I would like to refer you to a chapter by Rudolf Richter in the publication marking the 50th anniversary of the Deutsche Mark (Note: Fifty Years of the Deutsche Mark: Central Bank and the Currency in Germany since 1948). He writes that the culture of stability in Germany has been able to develop only because it has had the full backing of the general public. If you look at the

Maastricht Treaty, the relevant criteria are there. But you won't find any reference to the member states having to have the same culture of stability.

Weidmann: Political efforts to use the central bank for policy purposes exist in all countries. However, the public's stance on this is probably the crucial factor.

Is there a lack of political will?

Weidmann: The founding fathers of the EU treaties evidently took a sceptical view of the political will, and it is precisely for this reason that they made the central bank independent in order to protect it from a lack of or a conflict of political will. But the central bank must use and maintain this protection. Furthermore, it should be aware that this independence also requires it to respect and not overstep its own mandate. Mr Schlesinger's examples show that what is politically desirable and what is economically prudent have often not matched up. Whether we're talking about interest rates or some sort of non-standard measures, in the end it always comes down to the central bank being instrumentalised for fiscal policy objectives. However, policymakers thereby overestimate the central bank's possibilities and expect too much of it by assuming that it can be used not only for price stability, but also for promoting growth, reducing unemployment and stabilising the banking system. This pattern occurs again and again; this time it is perhaps even more pronounced than in the past because there is increased doubt among the general public about policymakers' ability to act, and the central bank is seen as the sole institution that is capable of doing something. In this respect, the central bank is perhaps under even more pressure than in the past – even though you, Mr Schlesinger, are better able to judge this as you have witnessed all of these periods. Furthermore, in Europe we are faced with some quite different ways of looking at the central bank's role – not only in politics, but also in the media and on the part of the general public. If a central bank also has to work against public opinion, things get difficult.

Today it is even harder for the Bundesbank to assert its influence as it is just one of 17 central banks in the Eurosystem. What impact does this have on your work?

Weidmann: Even though what you say is correct in terms of shares of voting rights, I certainly would not say that we are "just" one of 17 central banks. We are the largest and most important central bank in the Eurosystem and we have a greater say than many other central banks in the Eurosystem. This means that we have a different role. We are the central bank that is most active in the public debate on the future of monetary union. This is also how some of my colleagues expect it to be.

Recently, the day after a public hearing before the Budget Committee of the German Bundestag, the headline in the **Bild** ***newspaper read "Bundesbank is softening the euro". Did this discussion on inflation in the press, which was conducted in great depth and lasted for several days, harm the Bundesbank's status as an "anchor of stability"?***

Weidmann: Well, I have not received any complaint from Mr Schlesinger about that. He knew that this headline had no substance. For those acquainted with the Bundesbank it was immediately clear that nothing of any substance was being reported. Of course, it pains me to see how frivolously fears are being aroused, particularly at a time when people are already very uncertain. At the public hearing, the Bundesbank referred in terms of substance to something quite trivial: if Germany, which was once the "sick man" of Europe, is now taking the lead in Europe economically – and the economic situation has now been reversed compared with the first few years of monetary union – then this will, naturally, also have an impact on the inflation rate. However, it is positions after the decimal point that will be affected by this, and next year we shall in any case first of all see prices cooling off. Parallel to this, there was another, almost absurd debate about strengthening the peripheral countries by weakening Germany's competitiveness. This came about from the belief that the peripheral countries are at risk from deflation. However, if these countries go through adjustment processes which result in decreases in wages and prices, then this constitutes one-off shifts in the wage and price structure and not deflation.

Therefore, Germany does not have to accept inflation rates which broadly unmoor inflation expectations merely to ensure that the average euro-area inflation rate remains just below two per cent. Yet this is exactly what some in the United States and United Kingdom are calling for.

It is often said that Germany has benefitted from monetary union and it therefore has a duty to help.

Weidmann: I think that argument is incorrect. First, counting up the for and against of who has benefited to what extent from monetary union is not helpful. A stable single currency benefits all member states – some perhaps more than others, but that, too, can change over time. After all, Germany was certainly not considered to be a winner during the first few years of monetary union. Second, when monetary union was established, we agreed on a legal framework which has to be respected: a single monetary policy ensures price stability and each member state is responsible for its own fiscal policy. This is precisely what is expressed in the "no bail-out" clause. And third: Germany is already providing large-scale assistance for the peripheral countries, not least as an anchor of stability and as a guarantor of the rescue packages.

Mr Weidmann, in your opinion, what are the biggest challenges that the Bundesbank is facing now and in the coming years?

Weidmann: The crisis requires all our energies. We shall continue to use all of our resources at all levels to stand up for the positions we believe in and to ensure that the monetary union remains a stability union. We shall take on new tasks in the field of financial stability, which we shall have to breathe life into. I am thinking here, in particular, of the national macroprudential mandate, in which the Bundesbank is taking a prominent role. For me personally, it is a quite particular concern that we continue our progress to a culture of openness at the Bundesbank. The staff have already experienced the first elements of this new culture through "*Weidmann direkt*" and "*Zu Mittag mit …*". I have found this direct contact with members of staff to be very inspiring and useful.