Jens Weidmann: Sound public finances for a stable monetary union

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Institute for Law and Finance, Frankfurt am Main, 12 December 2012.

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1. Introduction

Professor Baums

Ladies and gentlemen

Thank you very much for your invitation. I am delighted to have the opportunity to speak to you today at the Institute for Law and Finance. There are many transmission channels between the "House of Finance" and the Bundesbank. The lively exchange of ideas between the two institutions has proven to be exceptionally fruitful, and it gives me great pleasure to further strengthen this dialogue today.

I will, however, resist the temptation to speak about "regulatory and fiscal policy aspects of the change of course in energy policy". Fascinating though this subject may be, giving a qualified lecture on this topic might ask a little too much of the central banker standing before you. And after all, it is the Bundesbank itself that regularly warns against too much being asked of central banks.

These warnings normally centre around central bankers' traditional fears about an excessively close relationship between monetary policy and fiscal policy. Mervyn King, Governor of the Bank of England, once summed up these concerns in slightly exaggerated terms by saying: "Central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with anything, it is with fiscal policy."

But where does this "obsession" come from? Why does escalating government debt pose problems for monetary policy? The reasons for this are not immediately apparent. After all, monetary policy – in the industrial countries, at least – is usually independent and equipped with a clear mandate to safeguard price stability. One could, therefore, incorrectly conclude that unsound public finances are not relevant to monetary policy.

However, a closer look reveals that monetary policy is reliant on fiscal policy with regard to safeguarding price stability. Escalating public debt inevitably drives prices higher. But growing government debt can still pose a threat to price stability even before it begins to spiral out of control.

Furthermore, a host of empirical studies suggest that high levels of public debt dampen growth over the long term. Seen from this angle, the prevailing situation in the euro area – but also in other industrial countries such as the United States and Japan – might lead one to assume that there is a broad consensus in favour of rapidly and resolutely reducing budgetary deficits.

Yet critics raise a number of objections to these arguments. First, they claim that the risks to price stability in the current environment are not acute, that inflation rates are low and inflation expectations are still firmly anchored. Second, they warn that rapid consolidation in these countries would set off a cyclical downward spiral – they would "save themselves to death", as it were.

Bearing this in mind, I would therefore like to focus on three topics in a little more detail: first, the importance of sound public finances for price stability; second, the preconditions for sound public finances in the monetary union; and third, the cyclical effects of fiscal consolidation.

To begin with, let us consider why monetary policy can only be successful in the long run if public finances are sound.

2. The importance of sound public finances for monetary policy

High levels of government debt make it difficult to safeguard price stability in more ways than one. As I have already indicated, an excessive debt level can cause growth impetus to slacken over the long run as the increased public borrowing requirement pushes up interest rates, making investment more expensive and thus diminishing growth.

If the central bank does not identify this slowdown in growth in good time, its monetary policy stance will be too expansionary and thus ultimately raise the spectre of inflation. But even if the central bank does correctly identify the deceleration of growth, it might come under mounting pressure to adopt an excessively expansionary monetary stance in order to stimulate the economy and thus maintain the usual rates of expansion. The longer the central bank tries to use monetary policy means to mask the structural slowdown in growth, the less credible it becomes in terms of its price stability objective. This can send inflation expectations higher and ultimately fuel inflation.

However, a structural slowdown in the growth outlook is not the only problem that excessive public debt holds in store for monetary policy. If a government has already racked up high levels of debt in economically good times, fiscal policy can no longer fulfil its role as a buffer when a crisis occurs. Under normal circumstances, fiscal policy measures can stabilise aggregate demand during a cyclical downturn, for example via unemployment benefits or an automatically falling tax burden. This path is not available if such fiscal policy measures call the sovereign's solvency into question. This applies not only to the traditional countercyclical fiscal stimulus measures I have just mentioned, but also to cases where the crisis has hit the banking system and government support is essential to prevent credit institutions from collapsing. If fiscal policy cannot provide this support, the central bank may, in the last resort, be forced to prop up the banking system. These measures considerably increase the central bank's balance sheet risks and might thus impair the credibility of monetary policy.

A high level of public debt can increase the pressure on monetary policy not only to provide an economic stimulus or to step into the breach in the event of a crisis, but also to generally ease the financing conditions for government. The monetary policy measures that can be deployed in this case range from interest rate cuts to bond purchases through to direct monetary financing by the central bank.

Government interest expenditure depends not least on the interest rate level and thus on monetary policy. If a country is only growing at a slow pace but has already run up high deficits and debt levels, its interest costs must be kept below a certain threshold, or else the government debt ratio could explode. If the sovereign then – for the purpose of maintaining its solvency – obliges the central bank to set a lower interest rate than price stability would require, demand would rise too quickly, thus leading sooner or later to inflation. Among economists, this state of affairs is known as a regime of "fiscal dominance": interest rates are no longer set on the basis of what is needed to safeguard price stability but are geared instead to the government's need to lower its financing costs.

Providing economic stimulus, taking on fiscal policy tasks in a crisis, financing the sovereign: the pressure that unsound public finances exert on monetary policy comes in many different guises. To resist these influences, legislators conferred a high degree of independence on central banks. This came in response *inter alia* to the experience of the 1970s and 1980s, a period in which oil price shocks posed a major challenge to monetary policy. It became evident that countries with independent central banks had significantly lower inflation rates than those in which central banks followed politicians' instructions – while simultaneously achieving equal or even higher levels of growth.

What we learned back then was that price stability does not run counter to economic prosperity but complements it. This has proved to be one of the key economic policy lessons of the past thirty years. The decision to make central banks independent of government instructions was a resounding success in fighting inflation. And the level of public debt no longer appears to have influenced inflation levels over the past few decades, at least in the industrial countries.

Yet to conclude from this that an independent monetary policy alone is a sufficient condition for stable money would, in my view, be premature, if not to say naive. For if a sovereign runs up so much debt that the burden soon becomes unsustainable, the central bank comes under much greater pressure. This can raise concerns as to whether the central bank is truly independent and can undermine its credibility – even if it has not yet actually changed its monetary policy course. Once the first doubts emerge as to whether monetary policy can assert its independence, the central bank runs the risk of losing control over inflation expectations, and thus over inflation itself.

At this point, sceptics like to raise the objection that high inflation expectations do not necessarily imply rising inflation rates, claiming that only expanding demand can fuel inflation. However, inflation rises as soon as inflation expectations increase, even if demand does not go up *per se*.

The wage-setting process is a good illustration of how this mechanism works. Wages cannot normally be changed at any point in time but are usually set on a given date for a given period. Employees therefore take account of anticipated price developments when negotiating their wages in order to prevent their earnings from deviating too strongly from a suitable level during the subsequent period in which they cannot renegotiate their wages. If they overestimate inflation, their wages would be too high and they would not be competitive. If they underestimate inflation, they would lose real income and their purchasing power would shrink as a result. Inflation expectations are thus factored into today's wages and thus into today's prices as well. DE-anchoring inflation expectations can therefore lead directly to higher inflation.

Recent research findings[1] suggest that it can take some time for a central bank that has a credible track record to forfeit its credibility. Indeed, this is a process that could well last several years.

However, once a central bank has lost its credibility, inflation expectations may surge dramatically. Bringing them back under control can be both time-consuming and costly for the economy.

3. Preconditions for sound public finances

Sound public finances thus remain a necessary precondition for price stability. And ensuring sound public finances is even more crucial in the monetary union. This is because one of the fundamental problems of a monetary union featuring decentralised fiscal policies is that member states have a greater incentive to incur debt. When government debt in one country rises, the consequences are spread across the entire monetary union and are thus effectively diluted – for example, via rising interest rates for all of the member states. This makes incurring higher deficits more attractive to each individual country.

To counteract this moral hazard, the European monetary union was placed from the start on a stability-oriented foundation. In addition to the prohibition of monetary financing, this foundation is underpinned by the strict deficit rules enshrined in the Stability and Growth Pact and the no bail-out principle with regard to other member states.

So long as the no bail-out principle maintains its credibility, it sends an important signal to the financial markets. If investors believe that they themselves could face potential losses, it was assumed that they would demand higher interest rates in return for the increased risk. The guiding principle of monetary union was therefore based on individual responsibility: both on

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[1] Bianchi, Francesco, and Leonardo Melosi (2012), Dormant Shocks and Fiscal Virtue, Duke University, mimeo.

the part of the member states, by assuming individual responsibility for the consequences of their policies, and on the part of the financial market agents, by assuming individual responsibility for the consequences of their investment decisions.

Despite these rules, however, member states' borrowing has not been effectively curbed since the introduction of the euro. In fact, quite the opposite has happened. With regard to the Stability and Growth Pact, the rules were not only circumvented but also actively bent. A key shortcoming was that a majority of all member states had to vote to impose sanctions on countries which exceeded the deficit limit.

A second problem was that the financial markets did not exert the expected disciplining effect. Investors tolerated the fiscal and economic policy failures of several member states for far too long, either because they overlooked the growing risks or because they did not see the no bail-out policy as being credible.

The fact of the matter is that, in the case of the no bail-out policy, a key factor was underestimated, namely contagion effects via the member states' financial systems. The introduction of the euro led to an intensified integration of the financial markets. But the crisis has shown that this is not always a blessing, as the probability of contagion effects increase significantly across closely interconnected financial markets. This means that when a crisis occurs, not providing assistance can prove very expensive. Financial assistance, at least in the short run, seems to be the lesser evil, especially where banks have already been weakened on account of past failures and the financial and economic crisis.

In spite of this, many of the considerations which shaped the construction of the monetary union at the end of the 1990s essentially still remain valid. Fiscal rules can certainly play an important role in reducing the incentive to run up debt – at least where governments are bound by them. A number of measures have been taken since the outbreak of the crisis to improve these rules. The reform of the Stability and Growth Pact has made it much harder to undermine the deficit rules. And the Fiscal Compact additionally strengthens the excessive deficit procedure and anchors the rules for pursuing a sound budgetary policy at the national level. It now remains to be seen how these new rules will be put into practice.

For experience shows as well that, in addition to rules, a stability-oriented policy approach also calls for a fundamental consensus both among politicians and the general public which upholds and protects these rules. There is also reason to fear that the crisis measures have tended to further amplify the aforementioned incentive to incur debt. This can be attributed to the fact that while risks have been extensively mutualised in the wake of combating the crisis, the control over fiscal policy still remains in the hands of each country. This divergence of liability and control makes it even easier to shift the consequences of unsound fiscal policy onto others.

Essentially, there are two conceivable approaches to realign liability and control and, in doing so, to create a stable monetary union. The one is to take a quantum leap towards a genuine fiscal union, featuring an extensive transfer of budgetary policy sovereignty to the European level. The other is to try to reassert the principle of individual responsibility, which is the basis of the Maastricht Treaties, in practice. To overcome the remaining weaknesses of monetary union, further integration would be required in this case, too, though it would be less extensive than in a fully-fledged fiscal union.

Unfortunately, it must be said that currently neither of these two approaches is being pursued resolutely. Taking the path of fiscal union would require countries to surrender a substantial amount of their sovereignty. However, such a significant increase in integration lacks majority support in many member states. In fact, I have noticed that it is precisely the people who most vociferously call for mutual liability are the ones who most vehemently reject transferring national decision-making powers to the European level.

A crucial requirement of the second option – returning to a system of national fiscal responsibility – is that solvency risks are not extensively mutualised and that financial market players bear the risks of their investment decisions themselves. This would lead to financial market discipline playing an even greater role. However, with a view to a future stable regulatory framework, it is not helpful that decisions have been made that weaken this disciplinary effect.

Regardless of which path monetary union takes, it must be ensured that, in future, budgetary imbalances of one country do not automatically jeopardise financial stability. Otherwise, other countries would feel compelled to use all means necessary to prevent a sovereign insolvency for the sake of safeguarding financial stability, so that a disciplining effect on fiscal policy would be unlikely from the outset.

For this reason, too, a resilient financial system is central to a stability-oriented monetary policy and a functioning monetary union. A well-structured banking union, which severs the problematic ties between sovereigns and banks, can make an important contribution to this. I could easily speak about banking union for another half an hour, but I will leave it at that for now.

Instead, I would like to sum up this issue as follows. Price stability requires sound public finances, and sound public finances call for a coherent framework for monetary union. However, the question of designing the overall framework does not solve the problem of the current deficits.

4. Consolidation versus growth

Since the outbreak of the sovereign debt crisis, a number of euro-area countries have introduced steps to consolidate their budgets. Critics, such as the American economist Paul Krugman, caution that such consolidation will cause more harm than good in the present circumstances. In order to reduce the deficit, he argues, countries either have to cut public spending or increase taxes. But , he adds, both of these measures are the wrong remedy in the light of the current economic slowdown as they would further dampen the already weakened aggregate demand and hence trigger a downward economic spiral.

This debate has gathered further momentum following a study performed by the IMF[2] on the size of fiscal multipliers in the crisis. This multiplier indicates how strongly economic growth reacts to a change in budgetary policy. The IMF's study arrives at the conclusion that the multiplier amounts to approximately 1.7 and is thus larger than originally assumed. This would imply that growth losses would be much greater than the consolidation savings. In this case, budgetary consolidation would actually trigger a downward spiral.

However, the IMF's findings are disputed among economic researchers. The sceptics criticise, first, the small number of observations and, second, the high dependency of the results on the choice of countries in the sample. Furthermore, the situation in the individual countries is likely to vary greatly, but this variation is not sufficiently accounted for in the IMF's cross-section analysis.

There is no disputing that austerity measures can impede growth in the short term. But it is equally indisputable that the debt situation in the countries concerned is simply unsustainable. I therefore believe that there is no alternative to resolute consolidation. This is the logical consequence of the fact that this crisis is essentially a crisis of confidence. In order to restore confidence in public finances, fiscal policymakers must now show that they are able and willing to improve their structural budgetary position. Although fiscal consolidation is hard, it is unavoidable in a debt crisis – constantly deferring the necessary measures will only increase uncertainty and thus likewise dampen growth. And a deliberately

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2 International Monetary Fund, World Economic Outlook 2012.

protracted consolidation of public finances would also make it harder to maintain political support.

Incidentally, the way in which consolidation is carried out also plays an important role in determining how quickly a country returns to healthy growth rates. Studies[3] show that countries which reduce their deficit by cutting government expenditure sustain significantly smaller growth losses than countries which do so by increasing taxes. The rationale behind this is that many measures such as streamlining the administrative apparatus or privatising state-owned enterprises not only yield potential savings for the public sector but could also improve macroeconomic productivity.

5. Conclusion

Ladies and gentlemen

The high level of public debt is one of, if not the, greatest economic policy challenge of our time. This applies also, and especially, to monetary policy. Sound public finances are a precondition for a stable currency, a precondition that monetary policy cannot create itself.

In order to ensure sound public finances in the euro area over the long term, the architecture of monetary union has to be further developed in a coherent manner. In doing so, particular attention must be paid to keeping liability and control in harmony. And it is crucial that such a culture of stability is actively embraced by both policymakers and the general public.

Consolidation and growth do not conflict with one another. Instead, the one is the precondition for the other.

To say it in the words of the American economist Paul Romer: “A crisis is a terrible thing to waste”. That puts it in a nutshell. If Europe resolutely executes the necessary reforms, monetary union will end up stronger. Of this I am certain.

Thank you.

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[3] Alesina, Alberto, Carlo Favero, and Francesco Giavazzi (2012), “The output effect of fiscal consolidations”, Harvard University.