Jens Weidmann: Crisis management and regulatory policy

Text of the Walter Eucken Lecture by Dr Jens Weidmann, President of the Deutsche Bundesbank, given at the Walter Eucken Institute, Freiburg, 11 February 2013.

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1. Introduction

Professor Feld

Ladies and gentlemen

I am delighted to be here today to give the Walter Eucken Lecture.

And I am delighted that so many of you have come today on Rose Monday, the highlight of the German carnival season before the beginning of Lent, to listen to a monetary policymaker.

Monetary policymakers do not have the reputation of being over-blessed with a sense of humour – there is therefore some doubt about our suitability for the carnival season. On the other hand, the immunologist and humourist, Gerhard Uhlenbruck, said that, at carnival time, we wear a mask so that we can let it slip. I will certainly not be putting on a mask and under no circumstances will I attempt to give an amusing speech.

Instead, I shall be talking about regulatory policy and, more generally, economic policy principles and about their importance in the crisis as well as in overcoming it.

To many, "regulatory policy" will perhaps sound somewhat old-fashioned at first. Think back, for instance, to the debate in 2009 on the future of regulatory policy professorships at German universities. That debate concerned the question of whether regulatory policy should remain an important part of university economic teaching or whether priority ought not to be given to modern quantitively-oriented research.

I personally was and I am unable to get much out of this debate. Both are important; each complements the other. We need a normatively founded economic policy framework; in other words, a general compass based on tried and trusted principles. In the same way, we need modern economics, that is an economic science which analyses economic relationships using quantitative methods.

Problems arise, however, if the measurability of economic relationships fosters the illusion that they can also be policy-managed accordingly. James Buchanan, Honorary President of the Walter Eucken Institute, who died recently, correctly noted in 2009 that "Unfortunately, economists, generally, failed to understand that aggregate variables that may be measured with tolerable accuracy ex post may not be variables subject to control, directly or even indirectly."

Apart from that, just because something is old, it doesn't necessarily mean that it is also outmoded. That goes for traditional regulatory policy. It also applies to the independence of central banks and price stability as its primary objective. And it applies to the basic principles of monetary union.

These are not all theoretical concepts designed on the drawing board and having no practical relevance, which are past their sell-by date as a result of the crisis. Quite the opposite: they represent the sum total of a great deal of historical experience, not least of major crises in the past.

The regulatory concepts of the post-war era were shaped by the experience of the global economic crisis and the totalitarian command economy. The monetary policy paradigm and the framework of monetary union grew out of the adverse experience gained from inflation and politically dependent central banks.

The current crisis has not made regulatory policy obsolete, nor has it removed the ground from under the principles of monetary policy and monetary union. On the contrary, the crisis has, above all, shown once again how relevant these guiding economic policy principles continue to be.

In my following remarks, I would therefore like to show how and why these guidelines are indispensable for solving our current problems and for preventing future crises.

2. Regulatory policy and monetary union

Walter Eucken is regarded as the founding father of German ordoliberalism, developed by the Freiburg School. The core element of ordoliberalism is competition, but not classical unrestrained competition but protected, ordered competition. The ordoliberals' objective was always to provide a stable environment for competition, not to actively manage it.

This idea was taken up and modified by the proponents of the social market economy. They identified a need for government economic policy that went beyond setting a framework. But such a government economic policy was to be consistent with market principles and adhere to the principle of subsidiarity – what can be regulated by the market should be regulated by the market.

The entire Maastricht framework reflects key ordoliberal and social market economy principles.

- It is geared to the principle of open markets: in the single European market, this principle is safeguarded by four basic freedoms.
- It is geared to the principle of subsidiarity, which is explicitly enshrined in the EU Treaties.
- It is geared to the principle of liability, which was incorporated as a "no bail-out" clause into the EU Treaties – according to which no member state shall assume liability for the debts of other members.
- And it is geared to the primacy of monetary policy – something which, on professional grounds alone, I feel very strongly about.

For Walter Eucken, too, monetary policy was of central importance. As he wrote, for example, in "Principles of Economic Policy", "All efforts to achieve a competitive system are in vain unless a certain monetary stability is assured. Thus, there is a primacy of monetary policy in competition order."

According to Eucken, the monetary constitution was to be organised in such a way that it guaranteed money had a stable value. This requirement is important not least because the instruments of monetary policy are very effective and can be used for purposes other than keeping the value of money stable.

Politicians, for example, have always been tempted to harness central banks to their cause in lowering unemployment, boosting economic growth and supporting government budget funding.

In particular, the various episodes of high inflation during the 1970s taught us, however, that the role of central banks should be limited and that central banks have to be protected from being co-opted for other purposes.

The lessons from that period played a major part in the establishment of European monetary union: the European System of Central Banks is, first, free from political influence and, second, has a clearly defined mandate with price stability as its primary objective.

The primacy of monetary policy is additionally protected by the prohibition of monetary financing in the EU Treaties and by the fiscal rules of the Stability and Growth Pact. And that, too, is based on the lessons of history.

A high level of borrowing increases the pressure on the central bank to finance government debt with the help of the printing press so as to make the straightjacket of budget constraints slightly less tight. Being instrumentalised in this way easily leads to high inflation, however.

There are instances of this ranging from the Latin Monetary Union in the second half of the 19th century up to the recent past. And such a situation is by no means confined to developing countries or to exceptional situations, say, in times of war.

In that respect, the "marriage" between Banca d'Italia and the Italian Treasury was not a happy relationship either. Between 1975 and 1981, Banca d'Italia was obliged to act as buyer of last resort for government bonds. Even though correlation does not imply causality, it is nevertheless worth noting that, during this liaison, government debt rose from 18 trillion to 100 trillion lire and that annual inflation amounted to almost 17% on average. By way of comparison, inflation in Germany during this period was roughly 4½%, and in Switzerland only 3%.

Excessive government debt therefore represents a massive threat to price stability. Putting an effective limit on government borrowing is thus a primary pillar of any policy of stable money. Monetary union, as a union of stability, therefore required sound public finances.

Having said that, it soon became clear that calling for sound public finances would not be enough. A requirement of this kind had to be reinforced by fiscal rules.

In this context, a part was played by the following considerations. First, the finding that public budgets have a tendency to excessive borrowing; think, for instance, of the theory of political business cycles. Second, the concern that governments in a monetary union have an even greater incentive to borrow because the costs of an unsound policy can be spread more widely. And, third, from the outset there was the fear that, despite the no bail-out principle, market discipline on its own would not be enough to control such a tendency to incur debt.

3. Monetary union and crisis

The framework of monetary union was quite coherent, it reflected well-established regulatory policy principles, and the attempt was made to learn the lessons and not to repeat the errors of the past. Nevertheless, the crisis has shown that, in some places, this framework was too weak.

The fiscal rules, for example, lacked the necessary bite. Instead, the reform of the Stability and Growth Pact in 2005 in fact saw some of its teeth drawn as a result of political influence.

At the same time, the disciplining effect of the financial markets was even smaller than had already been feared. At times, the risk premiums for government bonds from the countries now in crisis shrank to a few basis points.

The fiscal rules and market discipline were thus too weak, and many euro-area countries ran up too much debt. In any event, the dangers that excessive government borrowing posed to monetary union were at least recognised. The dangers of unsound macroeconomic developments, on the other hand, were largely blanked out.

It is true that the 1989 Delors Report warned about potential imbalances resulting from the adjustment process after completion of economic and monetary union or from differing economic policy stances. In contrast to the field of fiscal policy, however, there were no precautions to limit such risks.

Thus, in the run-up to the crisis, housing bubbles and large current account deficits emerged, while many countries' competitiveness deteriorated. We see these developments now as being a root cause of the crisis; at the time, they were underestimated.

What was likewise underestimated was the importance of the financial system: feedback effects between the financial system and public finances, potential contagion effects across national borders, or the knock-on effects due to the distress of particularly important financial institutions.

Similarly, both the regulation of the financial markets and supervision were inadequate.

4. Crisis and regulatory policy

Ladies and gentlemen, the crisis has laid bare flaws in the regulatory framework of monetary union.

However, it would be wrong to conclude that we have to build an entirely new framework and give up the tried and tested regulatory policy principle. As a matter of fact, the framework's weak spots were located precisely where basic principles of economic policy had been neglected.

I would like to discuss two points in greater depth.

- The principle of liability, without which no market economy can function. To quote Walter Eucken again: "Whoever reaps the benefits must also bear the liability."
- And the primacy of monetary policy, as this has engendered a debate which could weaken the framework of monetary union in the long term.

4.1 Strengthen the principle of liability

Let me begin with the principle of liability.

One of the crucial questions is: how can competition and the price system be protected if the principle of liability is undermined by the problem of systemic importance?

This question concerns no fewer than two levels of monetary union: that of the financial system and that of sovereigns.

Think of the fall in risk premiums on government bonds which I mentioned earlier. Besides the general "hunt for yield", another hypothesis is that markets decided to forego risk premiums particularly because they were betting that no euro-area country would default.

The expectation of government bonds not defaulting was fuelled by the assumed systemic importance of individual euro-area countries. The reasoning goes that if the default of one country threatened the existence of monetary union, the other countries would jump in the breach to prevent more damage – despite the no-bail-out rule. This expectation put downward pressure on risk premiums on government bonds, thus distorting the pricing system; and we all know what happened next.

We face the same problem in the financial markets. If one bank looks likely to default and inflict damage on the entire financial system, the state will probably come to the rescue to prevent the situation from escalating – the bank is thus "too big to fail".

This leads to inadequate risk premiums for claims on this bank; they distort competition and encourage players to enter into even riskier transactions.

Yet systemic importance not only distorts the signals sent by market prices; it also, in a crisis, uproots the principle of liability.

In rescuing a systemically important bank, at least part of the creditors' losses are borne by the taxpayer. Excessively risky transactions therefore go unpunished, and a gap grows between benefits and potential damage. The same applies if a systemically important country is rescued.

The decisive question is thus how to give the principle of liability more heft – in the financial markets and among governments.

There are a number of approaches that could be taken at the level of the financial markets.

Higher capital requirements for banks are one such approach. They enable banks to shoulder greater losses by themselves and thus shift the risk back to the owner. Government bonds, in particular, should be adequately backed by capital in future.

Plans to ringfence certain risky banking business by creating independent trading units within banks are another such approach – they reduce internal cross-subsidising of risky trading business, thereby giving depositors better protection from the risks of such business.

The banking union is yet another. It shifts banking supervision to the European level and can thus ensure a better equilibrium with regard to liability and control between investors, national taxpayers and euro-area member states.

For this to succeed, the banking union needs not only a central supervisor but also resolution regimes which can help systemically important financial institutions, too, to file for bankruptcy without causing damage to the system while, at the same time, creditors participate in the costs of the institution's failure.

In order to strengthen the principle of liability at the level of sovereign states, the framework of monetary union needs to be improved. Even with regard to government finances, liability and control must be in equilibrium.

In the Maastricht framework, both liability and control were, essentially, located at national level. During the crisis, however, we moved away from this: control remained national, whereas liability has been increasingly transferred to the European level. While national governments take independent decisions on debt, the community is liable for the consequences.

This set-up is a breeding ground for renewed unsound developments. I therefore see only two convincing options.

Either we shift control and intervention rights to the European level as part of a fiscal union; or, in the sense of a return to the Maastricht framework, we strengthen the liability and independent responsibility of member states. Taken to its logical conclusion, this also means that we cannot – and must not – rule out the possibility of sovereign defaults.

As things now stand, however, it is not quite clear which of these two directions policymakers are leaning towards; they seem to be performing a balancing act, with one foot in the Maastricht world and the other in a fiscal union. In the long run, such a balancing act is painful and unhealthy.

4.2 The role of central banks

While policymakers vacillate, expectations of central banks increase. The Eurosystem is being cast as the only actor on the European stage with any ability to take any meaningful action. Accordingly, there are ever-increasing calls for the Eurosystem to do even more to resolve the crisis.

I consider this a bad idea, for two reasons.

First, the Eurosystem cannot resolve the crisis. The causes of the crisis are structural, and are to be found at the individual member state and the European level.

In an interview with the German daily newspaper Frankfurter Allgemeine Zeitung, the former IMF chief economist did not mince his words: "We have to fix the underlying structural problems. This will take time, but short-term policies just won't work. That is an insult to people's intelligence."

I have already mentioned some of these problems. Only policymakers can solve these problems; central banks cannot. To that extent, the discussion surrounding an allegedly overvalued euro is just a red herring to divert from the real challenges.

Quite apart from the fact that the relevant indicators are not pointing to major overvaluation, even despite the euro's recent appreciation, policymakers should adhere to the tried and tested assignment of roles.

Experience of politically motivated depreciations in the past has shown that these generally do not lead to any lasting gains in competitiveness. Often, renewed depreciations are necessary. If more and more countries try to depress their own currency, this can culminate in competitive devaluation, which will only produce losers.

The ECB's first president, Wim Duisenberg, pointed out something in 1999 – in a speech held in Paris, by the way – which still stands today: the EU finance ministers had agreed to issue "general orientations for exchange rate policy" only "in exceptional circumstances, such as in the case of clear and persistent misalignments of the euro".

Duisenberg continued by saying that "[s]uccessful and credible stability-oriented policies should help to prevent the emergence of misalignments in the future".

Exchange rate developments are naturally taken into account in monetary policy decisions inasmuch as they influence price developments. However, an exchange rate policy designed to weaken the euro intentionally would end up leading to higher inflation.

The second reason why the Eurosystem should not do even more is that the Eurosystem has already done much to contain the crisis. It has cut interest rates; it is supplying virtually unlimited liquidity to banks; and it has intervened in the bond markets.

With these measures, the Eurosystem – like other central banks round the world – has taken considerable risks, and it has stretched its mandate considerably. As Eucken might have put it: the primacy of monetary policy is no longer clearly evident.

As the UK bank HSBC's chief economist, Stephen King, put it, monetary policy has lost its political neutrality. He also notes that central banks round the world are redistributing wealth through their crisis measures. For example, by buying government bonds or imposing lax standards on collateral, the Eurosystem, in his eyes, is contributing to a redistribution of risks among the euro-area countries' taxpayers.

This redistribution is a very relevant problem in terms of the theory of democracy: in principle, only parliaments and governments, with democratic legitimacy, should be redistributing wealth – not politically independent central banks.

This problem takes on practical relevance when it is the basis on which people discuss whether or not central bank independence is an obsolete artefact. And this discussion has actually begun. Joseph Stiglitz has taken it a step further and is even calling for an end to independence in order to lend legitimacy to decisions taken by central banks to redistribute wealth.

At all events, this creeping or even open politicisation of central banks is causing me concern. The value of independent central banks is borne out not only by theoretical considerations but also by historical experience. I have already mentioned Italy as an example; England and France have seen similar experience, too.

Walter Eucken would object here: he took a dim view of independent central banks. As he saw it, experience had shown "that a monetary framework which gives monetary policymakers a free hand usually deems them capable of more than they should be regarded as being capable of doing".

As an alternative, Eucken championed a strictly rules-bound monetary policy. And this is also being given serious consideration, especially by those who feel that central bank independence has to be associated with a narrow interpretation of its mandate.

The question of whether rules-based policy is preferable to a central bank independence which, when it comes to the crunch, cannot be achieved anyway, was one of the topics at the latest annual meeting of the American Economic Association in San Diego

It must be recognised that the aim of a stronger rules-based policy framework is to prevent the primary objective of monetary stability from being watered down. Central banks use these rules to tie their own hands in order to avoid being co-opted by fiscal policy.

The price central banks have to pay for this, however, is that monetary policy also surrenders its flexibility. And it is precisely the decisive contribution made by central banks to stabilisation at the height of the crisis in the autumn and winter of 2008 which showed, in my opinion, just how important and useful such flexibility can be if it is firmly anchored in a clear commitment to the primary objective of price stability. However, the risks of such a policy are likewise becoming increasingly apparent.

Yet it is not only the benefits of independent central banks which are being questioned. On the heels of the crisis, changes to the monetary policy framework are being proposed which are designed to give monetary policy more policy options in times of crisis.

Quite some time ago, some – including IMF chief economist Olivier Blanchard – suggested that central banks should set higher inflation targets. Now the talk is of switching to nominal income targets.

The common idea behind price-level targeting or nominal GDP targets is that, following a period of low inflation or weak growth, monetary policy tolerates higher inflation rates for a time before returning to the target path, thereby giving the economy an additional shot in the arm.

I am sceptical of these proposals. A permanently higher inflation target creates permanently higher inflation costs; although level targets avoid this by allowing higher inflation rates only temporarily, they entail problems of their own.

Moreover, changing the monetary policy framework during a crisis could dent confidence in central banks and raise suspicions of ulterior motives behind a change in strategy.

In an article for the Financial Times, UK economist Charles Goodhart wrote: “Rather, a [nominal income] target would be perceived as a thinly disguised way of aiming for higher inflation. As such, it would unloose the anchor to inflation expectations (...)”.

Central banks’ hard-won credibility would suffer, and this would ultimately be too much to pay for greater flexibility. This credibility and confidence are the basis on which citizens have accepted the euro as a single currency.

And the debate on central bank independence or the benefits of alternative monetary policy strategies which imply at least temporarily higher inflation is anathema to this confidence. One of my predecessors described the risks of playing with inflation by saying that “if you flirt with inflation, you’ll end up marrying her”.

Eucken emphasised time and again, and I agree, that monetary stability is the basis for functioning competition, for a market economy and for general prosperity. However, I am also convinced that monetary stability is possible only with independent central banks whose mandate is focused on preserving price stability.

At all events, I am convinced that the crisis does not justify discarding this framework, which has proved its worth in theory and through practical experience.

5. Conclusion

Ladies and gentlemen, the economic policy principles which mark our economic order and monetary union are anything but outdated. They point the way towards a lasting resolution to the crisis.

A central economic policy challenge here is to give the principle of liability renewed heft, both in the financial system and in monetary union as a whole.

Another challenge is to preserve and protect the role of central banks as independent, clearly focused guarantors of monetary stability. I therefore wish to conclude by reiterating something Lars Feld said in a 2011 interview with the German newspaper WirtschaftsWoche:

“I definitely recommend that all politicians put under their pillows a copy of Eucken’s book Principles of Economic Policy”.

Thank you for your attention.