Jens Weidmann: Striving for a stable framework for monetary union – an old debate revisited

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, to the Ambassadors Conference, Berlin, 26 August 2013.

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1 Introduction

Your Excellency Dr Guido Westerwelle
Minister of State Ms Cornelia Pieper
Minister of State Mr Michael Link
State Secretary Ms Emily Haber
State Secretary Mr Harald Braun
Heads of Germany's missions abroad
Your Excellencies the Ambassadors
Ladies and gentlemen

Thank you very much for inviting me to this conference. I'm delighted to have the opportunity to speak to you here today.

Inviting the President of the Bundesbank of all people to an ambassadors conference might appear somewhat unusual at first glance. After all, central bankers are hardly renowned for having the most thrilling of professions. "Boring is best" is how the former governor of the Bank of England Mervyn King once aptly put it.

But whether we like or not, my profession has been attracting ever greater attention. Rarely was monetary policy such a topic of intense public debate in the international arena as it is today. And incidentally, there are many channels which connect the Federal Foreign Office and the Bundesbank.

These notably include the secondment of Bundesbank employees to embassies and consulates in the major financial centres. As representatives at Germany's missions abroad, they provide information to interested local parties on European monetary policy, on the Bundesbank's role in the Eurosystem and on the German banking system. But information naturally flows in the opposite direction, too. These representatives regularly report on the latest economic and monetary developments in their host countries. This benefits the Bundesbank's analyses and, I would hope, those of the Foreign Office as well.

And the extent to which an additional perspective can broaden our perception of economic relationships was illustrated not least by the financial crisis. The outbreak of the crisis was not just a painful wake-up call reminding us that our theoretical models sometimes paint only a very incomplete picture of reality. Work is therefore quite rightly under way – at the Bundesbank and elsewhere – to develop a superior analytical toolkit that can be deployed in day-to-day work. This crisis has also been a stark reminder for us economists that looking back can offer valuable pointers for the future.

"History does not repeat itself, but it does rhyme." This saying by Mark Twain quite aptly describes economic developments as well. And it applies to the European debt crisis in equal measure. Twenty-five years ago, the European Council tasked a group of central bank governors chaired by Jacques Delors, then President of the European Commission, with identifying ways in which a European monetary union could be structured. The Delors Committee's insights can teach us a number of key lessons to this very day. For many of the problems weighing down on monetary union today had already been flagged and discussed by the Delors Committee all of 25 years ago. That makes it worthwhile taking a look back in time.

My talk today will therefore be made up of three sections. In the first section, I would like to look at the Delors Committee's key insights. In the second part, I would like to examine why monetary union began to flounder, and I will then use these conclusions in the third section to develop proposals for strengthening the existing framework.

2 New problems, old questions

A single currency fosters economic relationships between different countries. Yet at the same time, it also increases the dependencies between them. This insight was a recurring theme throughout discussions within the Delors Committee. Their line of thinking was based on the economic policy experiences of the 1970s and 1980s. That era of oil price shocks posed a major challenge to monetary policymakers. 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 and steadies it.

But we learned something else, too. That an independent central bank is necessary for stable prices; but more than that is needed. A country suffering excessive public debt and a lack of competitiveness can cause upheaval within a currency area, and this can also impact on monetary policymakers' ability to fulfil their primary objective of ensuring price stability. In a currency union, monetary policy can only serve its purpose if each member state's economic policy is consistent with the requirements of a single currency.

The members of the Delors Committee discussed two possibilities of ensuring sustainable economic and fiscal policies. The first option was to transfer these decisions to the European level. This line of thinking was supported, among others, by Alexandre Lamfalussy, then managing director of the Bank for International Settlements (BIS).

The other option was the principle of individual responsibility, under which member states would remain largely independent in their choice of policies, but would be liable for the decisions they made. This liability principle promised to have a disciplinary effect. Member states running unsound fiscal policies or dubious economic policies would only be able to borrow at worse terms, since investors would demand compensation for the risk they were taking.

To make provisions in case the capital markets' disciplinary effect was insufficient, the fiscal scope was to be narrowed further still by way of a common set of rules. Jacques de Larosière, then governor of the Banque de France, was a notable proponent of a strict fiscal regime.

Both options were coherent on paper. Political considerations were the main reason why the principle of individual responsibility ultimately prevailed. The bulk of member states were not prepared to relinquish any sovereignty in economic matters. It was widely feared that referendums held to change member states' constitutions would not produce a majority that favoured a large-scale transfer of sovereign powers.

And this was how the architecture of monetary union made up of sovereign nation-states that we are familiar with today, came about. As before, national parliaments bear full responsibility for such vital areas as tax policy, budget policy or labour market regulation.

3 Vulnerabilities in the original framework

Ladies and gentlemen, what the Delors Committee tried to achieve back then was to find an architectural model capable of accommodating this inherent tension. They sought to construct a stable European house, knowing full well that tremors in individual member states might shake the structural soundness of the entire building. Why was the draft made back then unable to prevent the crisis we are experiencing today?

First, it should be noted that although one key point – the risk of macroeconomic imbalances – was indeed recognised by the Delors Committee, consideration was not made for it to be incorporated into the final Maastricht framework. The Maastricht framework instead focused on the one central supporting pillar: the fiscal rules designed to curb government deficit and debt levels. These rules were complemented by the no bail-out clause – that is, the principle of individual responsibility. But this pillar proved unable to provide sufficient support. The rules designed to curb government deficits didn't have sufficient binding force. Repeated breaches knocked more and more stones out of the "fiscal rules" pillar, with Germany bearing much of the responsibility for this.

In the end, other pillars supporting the structure likewise proved to be brittle. Banking supervision remained a national responsibility, which meant that there was no institution which set the same high standards for banks, irrespective of their home country, and took account of cross-border interactions which were outside the field of vision of national supervisors. While it is true that a few members of the Delors Committee, like Wim Duisenberg, later President of the ECB, spoke out in favour of common banking supervision, their proposals fell on deaf ears.

The capital markets' disciplinary effect on governments likewise proved to be inadequate. Why that didn't work is quite easy to explain. Back then, a different committee, which like the Delors Committee also met in Basel – the Basel Committee on Banking Supervision – made what turned out to be a momentous decision for the euro area. The new common set of international capital rules stipulated that government bonds be valued as risk-free assets, which meant that banks did not have to back them with capital.

This decision affected monetary union in two ways. First, it cast doubt over whether the no bail-out clause could ever be enforced, given the huge differences in economic power and indebtedness between the member states. Second, sovereign insolvency became less credible for reasons of financial stability. But if banks do not set aside any capital for government bonds, a sovereign default can hit the banking sector head on, potentially triggering a financial crisis.

4 A new home for monetary union

As we can see, the home shared by the member states of the euro area needs renovating in more ways than one. Of course, numerous methods are conceivable for constructing a stable dwelling. That's just as true today as it was then. As an alternative to the "Delors house", one could also imagine building a dwelling that does without the supporting pillars known as "fiscal rules" and "individual responsibility" and is instead held up by the "fiscal union" ring beam.

However, a properly functioning fiscal union would depend on the member states transferring a substantial degree of national sovereignty to the community level by giving the community the necessary right to at least intervene in the event of unsound public finances. Transferring sovereignty on this scale would be a radical change that would require wide-ranging legislative changes nationally and at the European level. And above all, such a step towards greater integration would require not just political support but public backing as well. On this point, however, we should remain realistic. The will to do so is barely discernible at present – in the midst of the crisis – not here nor in any of our partner countries. Seen from this angle, the situation has hardly changed since monetary union was launched.

All that remains, then, is to stabilise the building we have, focusing our renovation efforts on the current supporting structures. This means, first, strengthening the common set of rules. And, second, it means lending renewed force and making enhancements to the principle of individual responsibility, which has been further eroded by a number of the crisis measures.

Construction activity is already largely complete on the fiscal rules. But only actual practice will show whether the new Stability and Growth Pact and the Fiscal Compact will really make

lasting improvements to the structural soundness of the building – that is, whether the patched-up pillars can bear the weight.

After all, it is not enough to merely have a "new" set of tighter rules; these rules actually have to be applied and filled with life. This is a matter in which the European Commission has a particular responsibility because it has considerable discretionary powers in interpreting the new rules. I would not consider it appropriate to stretch the flexibility of the rules to the absolute limit from day one.

In its August Monthly Report, the Bundesbank examined the recent decisions by the Ecofin Council regarding the excessive deficit procedures for euro-area countries from a critical perspective. Spain, France, Slovenia and Cyprus were each granted longer deadlines to make adjustments than were actually envisaged in the Stability and Growth Pact. Derogations of this kind should, however, be reserved for well-justified exceptional cases. For this ultimately results in a weakening of the structural consolidation requirements and corrective action being pushed into the future. Granting exceptions to a number of countries simultaneously undermines the disciplinary effect of the fiscal rules.

And the new Macroeconomic Imbalance Procedure should likewise be applied as rigorously as possible. While the construction of the extended set of economic and fiscal rules is already at an advanced stage, work on Europe's largest building project is still in full swing.

And by that, I am referring to the banking union. If implemented properly, it can perform two tasks. First, it can rectify competitive deficiencies in the banking sector; second, it can enhance the capital markets' disciplinary effect on governments. Both problems are closely intertwined; neither can be resolved in isolation.

After all, both sets of players – banks and sovereigns – have one thing in common. They were only subject to the key market economy principle of liability to a very limited degree in the past. Both were considered to be systemically important. It was feared that if they got into problems, this might jeopardise the stability of the financial system. In the end, it wasn't the decision makers who were liable. But this is something that undermines the incentives for responsible behaviour.

In the midst of the crisis, the weakness of one set of players then became that of the other. Banks that had run into difficulties on account of distressed property loans in their books, say, had to be propped up by the taxpayer. The rescue sums required in countries like Ireland, Cyprus and Spain were so huge that sovereign solvency, too, began to be called into question by investors. This drove refinancing costs higher.

But the negative feedback loop also works in the opposite direction. Ailing states can bring down banks that have substantial holdings of sovereign bonds in their books. It is this strong link between sovereigns and banks that needs to be severed.

Separating the two is all the more important because the nexus between banks and sovereigns actually even increased at times during the crisis. Studies[1] *[1]*suggest that it was notably the poorly capitalised banks in the crisis-hit states which took advantage of central bank refinancing to invest increasingly in high-yield domestic government bonds during the crisis.

For when the insolvency of the home country is highly likely to bring down the institution in question as well, it can actually be quite rational to ramp up risk levels further still. After all, this barely increases the bank's risk of insolvency but distinctly boosts the prospective profits if the outcome turns out to be favourable.

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[1] V Acharya and S Steffen (2013), The "Greatest" Carry Trade Ever? Understanding Eurozone Bank Risks, Working Paper, NYU Stern School of Business.

Hence, this strategy further intensified the negative feedback loop between banks and sovereigns during the crisis. Several incisions will be needed if we are to sever these links. The first of these will be the Single Supervisory Mechanism, which is tasked with preventing banks from getting into difficulties at an early stage.

But these are problems that cannot be entirely ruled out in the future, nor would we want to do so. After all, the possibility of failure is vital for a functioning market economy. It is important, therefore, to be able to allow banks to fail without governments – and thus also taxpayers – having to foot the bill.

And that is why we need the European recovery and resolution mechanism. Its job will be to ensure that if a credit institution needs to be restructured or wound up, its owners and creditors will bear a fair share of the losses. This guarantees that those benefiting from investment income also carry responsibility for the associated risk.

But the feedback loop between sovereigns and banks needs to be severed in the other direction, too. The close ties linking sovereigns to banks are largely the result of the substantial volumes of government bonds which banks have in their books. This is where we need to make a further incision. First, government bonds should be backed by a sufficient quantity of capital. Second, the volume of loans that banks can extend to individual sovereign debtors needs to be capped.

In a nutshell, over a medium-term horizon, government bonds should be treated just like other bonds or loans to enterprises. For the previously held notion that government bonds are entirely free of risk runs counter to the principle of individual responsibility as well as recent experience. Appropriate risk-weighting would drive yields higher for unsound sovereigns and raise their refinancing costs. Hence, the market mechanism would force these governments to exercise greater fiscal discipline.

Yet the inadequate capital backing required for government bonds is not the only reason why they harbour risks for financial stability. Risk diversification is a key principle for investors. But this is a rule which European banks often tend to disregard where government bonds are concerned.

As I mentioned earlier, European banks frequently only have bonds issued by one government in their books, mostly those of their home country. In fact, these banks' holdings of government bonds as a percentage of their total assets are sometimes even higher than those of banks which spread their exposures across several sovereign debtors. This tightens the negative feedback loop between banks and sovereigns further still. And that is why we need limits on large exposures to individual governments as a vital addition to appropriate risk-weighting.

I am well aware that such a reform at the current juncture of the crisis might exacerbate the financing problems that some countries are experiencing. That's why I think that transitional periods might be acceptable as well. But abandoning a reform like this to suit short-term considerations would be the wrong approach.

Work on the major building project dedicated to constructing the banking union is far from complete. The capital rules for sovereign bonds are an example which vividly illustrates the tension that exists between what is right over the long term and the crisis management measures which appear to be needed in the short term.

5 The role of monetary policy

Yet this must not entice politicians to simply paper over the cracks rather than renovate the house from top to bottom. As you've probably already realised, I'm talking about the role of monetary policy. The ECB Governing Council agrees unanimously that monetary policy cannot solve the crisis.

The most it can do is buy time. Indeed, one of the Delors Committee's insights remains as valid as it ever was. In performing its task, monetary policy is bound by conditions that it cannot create itself. Monetary policy has already helped substantially in preventing a further escalation of the crisis. However, this has taken it a long way into uncharted – and dangerous – territory.

It's no secret that I am critical of the ECB's government bond purchase programmes in particular. If Eurosystem central banks buy government bonds issued by countries with poor credit ratings, this will distribute the risks of unsound fiscal policy among all the euro-area states. Monetary policy thus weakens the principle of individual responsibility and entails redistribution, which is really the prerogative of fiscal policymakers. Such redistribution can only be legitimately authorised by democratically elected parliaments and governments.

Thus, the most valuable contribution which monetary policy can make towards overcoming the crisis is safeguarding its credibility and upholding public confidence in the euro. It can do so best of all by focusing clearly on its primary mandate of safeguarding price stability.

6 Conclusion

Ladies and gentlemen

The crisis has caused the old debate over the architecture of monetary union to flare up again. And yet the construction principles sketched out by the first architects under the leadership of Jacques Delors remain as valid as ever. But when you take on complicated major projects like monetary union, things don't always work out at the first attempt – that's something we're probably not unfamiliar with in Germany.

It is now all the more important to rectify the remaining construction defects. Then it will be possible to make monetary policy what it once was – a boring task. And as Mervyn King quite rightly stated with his "boring is best" remark, there is nothing that we central bankers long for with greater fervour.

Thank you very much.