Jens Weidmann: The monetary union as a community of stability

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Bundesbank's parliamentary evening, Regional Office in Hamburg, Mecklenburg-West Pomerania and Schleswig-Holstein, Hamburg, 29 August 2013.

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1 Introduction

Madam President, ladies and gentlemen

I am glad of this opportunity to speak to you at this parliamentary evening.

I would like to begin with a short anecdote about the economist who lost his keys. One night a policeman notices an economist standing beneath a lamp-post looking for something. The policeman asks if he can be of assistance, to which the economist replies, "I've lost my keys and can't find them." The policeman asks, "Are you sure this is where you lost them, sir?" And the economist answers, "No, I lost the keys over by the car, but the light is better here."

People like to tell this story when rebuking economists because they didn't see the financial and debt crisis coming. Indeed, financial stability reviews and other economic studies prior to the crisis do contain references to shifts within the financial system. Yet the macroeconomic risks that this development on the financial markets produced did not receive nearly as much attention as they warranted.

This is because the economic models they used had blind spots. As a result, the financial markets were rudimentarily modelled at best. Looking back, one might say that impressive progress has been made in financial economics and macroeconomics over the past decades – but unfortunately they have advanced independently of each other rather than alongside each other. It is only recently that researchers have started to focus more strongly on the interaction between the financial sector and the real economy.

Yet that isn't the only moral of the story of the lost keys. Even when combating the crisis, there is a risk that we only see the obvious, what's right in front of our noses – like the fluctuations in the financial markets. But if we want to overcome the crisis once and for all, we have to illuminate the dark corners as well. Only if we identify and remedy the weaknesses in the framework of monetary union will we ensure that the monetary union remains a community of stability.

For this reason, my speech this evening consists of two parts. First, I would like to examine the main features of the current monetary union framework. Then I will discuss the options we have for stabilising the monetary union on a lasting basis.

2 The Maastricht framework

The creation of the European Economic and Monetary Union was a major step towards greater integration. Yet this integration was not developed to the same extent in all areas. Whilst a single monetary policy was put in place in the euro area, responsibility for fiscal policy and other important policy areas such as labour market policy have, for the most part, explicitly remained with the member states.

This so-called Maastricht Approach is geared to the principle of open markets, a principle that is guaranteed in the single European market by the four fundamental freedoms: free movement of goods, capital, services and people. The Maastricht framework is founded on the principle of subsidiarity, which was enshrined in the treaties of the European Union. It is based on the principle of liability, which was incorporated into the EU treaties as the no bail-out principle and which stipulates that – subject to certain limitations – no member state is allowed to assume liability for another's debts. And finally, it is based on the primacy of monetary policy. This is something which is particularly important to me, not least for professional reasons, and which was underscored by the independence of the central bank and the ban on monetary financing.

Ladies and gentlemen, in his book “Making the European Monetary Union”, the economic historian Harold James drew on a technical analogy to describe the challenge facing the Maastricht Approach. He wrote that, without a common fiscal regime and without a stable financial system, the monetary union had a very high centre of gravity that made for vulnerability and instability.

The crisis has again thrown the challenges confronting the Maastricht Approach into sharp relief. I am convinced of the importance of maintaining the euro as a stable currency. To stay with Harold James’ allegory, we must lower the centre of gravity of the monetary union so that it cannot be blown off-course so easily in future.

3 A reinforced framework for monetary union

3.1 Two paths to a stable monetary union

Before I proceed any further, let me say this: there is no “panacea” that will cure the “European patient” overnight. Indeed, the temptation to seek a “quick fix”, an easy, politically “painless” solution – we hear this kind of talk repeatedly in debates about the role of the central banks – is nothing short of dangerous.

The “acute measures” such as the provision of funds from the rescue packages, offer pain relief. They help to buy time for the necessary adjustments, but all they actually do is fight the symptoms. They cannot eliminate what caused the crisis.

It will take time until the causes of the crisis have been treated. This treatment should seek to remedy unsound developments at the national level while stabilising the framework of monetary union on a sustained basis. Thus, the very first priority must be to regain confidence in the soundness of the public finances of individual countries, in the stability of their financial systems and in the competitiveness of their economic structures.

This is where the adjustment programmes come in, providing assistance with conditions attached or promising “solidarity in exchange for solidity”. But at the same time, this assistance undermines the no bail-out clause to a greater or lesser extent, depending on the form it takes.

But it’s not just a matter of correcting national policy. Just as an earthquake reveals how structurally unsound a building is, so the crisis has exposed the shortcomings in the framework of the monetary union.

What is more, the architects of the Maastricht framework underestimated certain elements which exacerbated the crisis, such as the contagion effects between the individual countries or between banks and governments as well as the significance of national macroeconomic imbalances.

Essentially, there are two possible paths to a more stable monetary union. Either we dare to take the step towards deeper political integration or we enhance the current framework and strengthen the countries’ individual responsibility as a constituent element of the monetary union.

Deeper political integration could, for example, be a fiscal union. However, a fiscal union must not simply mean a greater mutualisation of liability: that would be a transfer union. A serious fiscal union would require the member states to transfer national sovereignty to the community level by giving the community the necessary right to intervene in the event of unsound public finances. Liability and control must be kept in balance if the incentive to incur debt, which is inherent in the monetary union, is not to be increased and if the monetary union is to prevail as a stable monetary union.

Such a transfer of sovereignty would be a radical move and require wide-ranging legislative changes nationally and at the European level. Above all, such a step towards greater integration would need not just political support but also public backing from the individual countries. On this point, however, we should remain realistic. The will to make these changes is not discernible at present – in the midst of the crisis – neither in Germany nor in any of our partner countries.

For the time being, then, our only option is the second path, namely to strengthen the present Maastricht framework. Amongst other things, this would involve giving the fiscal rules greater binding force, for they have been stretched and even ignored too often in past, with Germany not being entirely blameless in this respect. But that also requires the possibility of sovereign default as the ultimate logical conclusion of individual responsibility, without constantly endangering the stability of the European financial system.

In this respect, the "new" Stability and Growth Pact is a step in the right direction. But it is not enough to merely have a set of "new", tighter rules; these rules actually have to be applied and filled with life. This is where the European Commission has a particular responsibility given the considerable discretionary powers it has 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 those actually envisaged in the Stability and Growth Pact.

However, derogations of this kind should 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.

It is true that consolidation measures dampen growth in the short term; but from a long-term perspective, sound public finances and growth are not contradictory. On the contrary, only through sound public finances can sustainable growth be achieved.

Consolidating unsustainable public finances and running an efficient government create scope for economic activity in the private sector, thereby strengthening expansionary forces. What is more, consolidation is a crucial precondition for investors to regain confidence in the debt sustainability of the crisis-hit countries. This is the only way they can access the capital markets once more and shake off the need for assistance from partner countries.

Politically, such a path of consolidation is not an easy one to take. Yet it is interesting to note that the path of consolidation meets with more approval from the European general public than one might think, judging from remarks heard from political quarters. According to a survey conducted by the Pew Research Center, only around one third of Europeans questioned believe that the economic problems in their country can be solved by raising government spending. Contrary to common prejudices, the French in particular are for an expenditure-based consolidation, with 81% in favour. The figure in Spain is 67%, and 59% in Italy. In Germany, 67% of individuals polled want to see the present budgetary stance maintained. This broad consensus of opinion in the major member countries is an encouraging sign.

3.2 Setting up the banking union and accompanying regulatory measures

One of the lessons the crisis has taught is that the financial system needs to be reformed. It laid bare systemic vulnerabilities and revealed a fatal negative feedback loop between public finances and bank balance sheets which allows problems afflicting banks to spill over into the public sector. This is what happened in Spain and Ireland, for example. The bursting of the real estate bubble knocked a host of banks off balance, forcing the state to step in and itself run into difficulties.

But the mechanism works in the other direction, too, as we have seen in Greece and Cyprus. The solvency problems weighing on the Greek government impaired the value of sovereign bonds held in bank balance sheets, which meant that these banks then needed to be rescued. Besides jeopardising financial stability in the euro area, this negative feedback loop also neutralises a key tenet of the market economy – the no bail-out principle. Walter Eucken's oft-repeated principle that "those who benefit shall also bear the costs" offers importance guidance in this regard.

It was to rectify these problems that the large-scale institutional project entitled "banking union" was rolled out. The banking union consists of two pillars. The first is a single supervisory mechanism. The ECB is to be tasked with directly overseeing the most important banks in the euro area, around 130 in number, the aim being to ensure consistent compliance with high prudential requirements throughout the member states and to take account of cross-border interaction.

The SSM Regulation will probably be adopted by the European institutions this autumn, paving the way for the single supervisory mechanism to get to work by the ambitious deadline of autumn 2014.

The second pillar is a single resolution and restructuring mechanism. The rationale behind this instrument is that systemically important banks in the past relied on an implicit government guarantee. This encouraged them to run up disproportionately high risks and ultimately meant that they had to be rescued by the taxpayer. To reduce the likelihood of this happening in the future, there needs to be a way to wind up banks – ideally without the taxpayer having to foot the bill.

Thus, having the right sequence of liability is key in bank resolutions. Shareholders and creditors are the ones that should bear the losses. Deposits not only come last in the sequence of liability but are additionally protected under the deposit guarantee regime. If this protection proves insufficient, a resolution fund financed by banks will have to step in. The taxpayer should no longer be the first in line but the very last link in this chain of liability. A set-up like this can mitigate flawed incentives and imbue the no bail-out principle with renewed strength.

In July, the European Commission put forward its proposal for a European resolution and restructuring mechanism, which contains the sequence of liability I just mentioned. Other aspects of this mechanism, like the question as to which institution should have the final say in resolving a bank, still need to be debated over the next few weeks, of course.

However, the banking union should not already have a political millstone around its neck when it gets started. That is to say that strict and thorough reviews will be needed to bring legacy risks lurking in bank balance sheets out into the open. Any capital shortfall that comes to light ought to be covered either by shareholders or the capital markets. State aid should only be available to banks running sustainable business models.

Capital shortfalls arising on the watch of national supervisors ought to be covered at the national level as well; that is, by the banks' home countries. Anything else would be tantamount to a transfer, which should be disclosed as such. Balance sheet risks must not be smuggled to the community level under the cloak of the banking union.

Bank balance sheets always partly reflect national economic developments and a host of economic policy decisions. As long as key variables continue to be decided upon at the national level, introducing comprehensive mutual liability would be the wrong thing to do.

A banking union can help to sever the negative feedback loop linking governments and banks, and it can enhance financial stability. But further action will be needed if we are to prevent this vicious circle from simply being shifted from the national to the European level.

That means putting an end to the preferential treatment given to sovereign risk in bank balance sheets. Banks' substantial exposure to sovereign risk – which even increased in some quarters during the crisis – owed something to the 0% risk weight for government bonds and the absence of upper limits for lending to governments.

Putting an end to this practice of privileging sovereign debt over corporate loans would also represent a major step towards making lending to businesses more attractive again.

That's not the only regulatory measure that's of decisive importance. Higher capital requirements are key to ensuring that banks can withstand greater losses under their own steam, thereby shifting risk back to shareholders. This process got underway with the Basel III regime and now needs to be rigorously implemented.

Having a mechanism that facilitates the orderly resolution or restructuring of large, international and highly interconnected banks in the event of difficulties – otherwise known as the "too big to fail" problem – is equally important in future. Progress has been rather mixed so far on the implementation of internationally agreed standards for resolution regimes.

4 Role of monetary policy

Finally, I would like to turn to central banks' role in resolving the crisis. The causes of the crisis are structural. This is why only structural measures can resolve the crisis.

Monetary policy – that is, the Eurosystem – has already done a great deal to contain the crisis. The Eurosystem has cut key interest rates and it is supplying banks with practically unlimited amounts of liquidity. On top of this, in July ECB President Mario Draghi provided forward guidance on the ECB's future monetary policy stance, indicating that key interest rates would remain at present or lower levels for the foreseeable future.

Though the design details of these monetary policy measures are debatable, the action itself was essentially correct. However, the longer the phase of low interest rates continues, the blunter the loose monetary policy instrument becomes; risks to financial stability increase and the exit becomes more difficult.

The Eurosystem also intervened in the government bond markets, however, and raised the prospect of further interventions subject to certain conditions. You will be aware that I take a critical view of these steps.

For by purchasing government bonds of countries that are finding it difficult to place their bonds in the market, central banks are redistributing the burden of unsound fiscal policy throughout the euro area. Ultimately, this is tantamount to mutualising liability for the individual countries' debts via the central bank. Doing so blurs the boundaries between monetary and fiscal policy and might end in the independence of the central bank being called into question. Redistributing risk in this manner ought to be the sole prerogative of elected parliaments. And it naturally also weakens the no bail-out principle and lowers the pressure to reform.

The members of the ECB Governing Council do, however, agree that monetary policy cannot resolve the crisis. Only by implementing the aforementioned structural reforms in the member states and by making adjustments to the framework of monetary union will we succeed in overcoming the crisis in a lasting fashion and safeguarding the euro's future as a stable currency.

5 Conclusion

Ladies and gentlemen

Until the crisis erupted, practically no-one disputed that the European Union's evolution into a monetary union had brought benefits for all member states.

Yet the crisis in the euro area has placed an immense strain on the foundations of the monetary union, and many of the crisis management measures have skewed the equilibrium between liability and control. And we should take care that the entire package of crisis management measures in combination does not effectively create a new institutional framework which poses greater problems going forward.

Hence, a key challenge for economic policy will be to fill the no bail-out principle with renewed vigour, both in the financial system and throughout the monetary union as a whole.

Transforming the bank rescue packages already granted by the EFSF or ESM into ESM direct bank recapitalisation instruments – something which Ireland and Greece are looking to achieve – is not helpful in this connection.

And it is key to uphold and defend the role played by central banks as independent institutions with a clear focus on safeguarding price stability.

Thank you.