Jens Weidmann: The institutional and economic-policy challenges posed by the sovereign debt crisis

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, to the Economic Forum 2013, Darmstadt, 30 October 2013.

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1. Introduction

Professor Frömel
Mr Sellner
Ladies and gentlemen

Thank you very much for your invitation. I am delighted to have the opportunity to speak to you here today.

I have many good memories of Darmstadt. In particular, I look back fondly on my time as guest lecturer at the Technische Universität. I greatly enjoyed discussing matters of economic and monetary policy with students while I was Secretary General of the German Council of Economic Experts and Head of the Monetary Policy Division at the Bundesbank.

Besides what I personally associate with Darmstadt, the city is also a leading centre of science. This is clearly demonstrated by the fact that Darmstadt is the only city in Germany to have a chemical element named after it – the element Darmstadtium.

And of course, Darmstadt is also home to the European Space Operations Centre of the European Space Agency, ESA. Darmstadt might therefore be said to have something in common with Frankfurt. Whereas in Darmstadt, watch is kept over the 60 or so European satellites circling Earth, the European Central Bank in Frankfurt watches over the circulation of money throughout the euro area.

Reports such as "GOCE satellite mission completed" are acknowledged with interest by the experts without causing very much concern, because it means that the research satellite has successfully accomplished its mission. The fact that a satellite of this particular European joint project will break up upon entry into Earth's atmosphere in a few days' time is unlikely to plunge us into a state of shock.

It would be an altogether different situation if the European joint project known as the euro were about to crash. Thus, while European satellites are, from the outset, projects of limited duration, the euro is intended as our permanent common European currency – and a stable one at that. Despite this major difference, there is one key trait that the GOCE research satellite and the euro share. How well they function depends, among other things, on circumstances over which neither the ESA operations centre nor the Eurosystem have any influence.

Allow me to explain. The GOCE satellite was able to operate for a particularly long time because its fuel lasted longer than originally expected. This was thanks to the recent lull in the sun's activity, which caused Earth's atmosphere to expand less. As a result, there was less drag on the GOCE satellite as it orbited our planet. Believe you me – we at the ECB Governing Council would have preferred a lull in activity for the euro, too.

However, the fates of the euro are dictated not only in Frankfurt but, above all, in the capitals of the euro area. Political decision-makers lay out the course for the institutional framework of monetary union, but they also have a strong say in the economic and fiscal policy environment of monetary policy.

Now, after one-and-a-half years of recession, the euro area is again experiencing growth. Though this may be a reason for good cheer, I probably would not be a proper central banker if I did not seek to dampen the euphoria. As a former Federal Reserve chairman once

remarked, we central bankers are notorious for wanting "to take away the punch bowl just as the party gets going".

Indeed it would be premature to declare that the crisis is over, for even if the economic situation is picking up, many structural challenges still lie ahead. That applies to Germany, too. The economic situation is more favourable than that of other euro-area countries, yet a number of structural challenges – like the ageing of the population – are actually considerably greater in Germany.

Good progress has been made with the reforms in the crisis-hit countries, as the improved position in their current accounts and public finances demonstrates. Yet further efforts are needed in many areas, particularly to effectively combat the oppressively high unemployment levels in some countries. The euro area can only be strong and economically successful if its individual member states are, too. That is what makes the debate about the right reforms for each individual country so important.

But apart from that, we should not forget one central insight we learned from James Buchanan, the Nobel laureate in economics who passed away in January. Just as important as the discussion about economic policy itself is the discussion about the right framework conditions and incentives under which economic policy is conducted.

What I am referring to is regulatory policy. Each of us knows from our day-to-day life how difficult it can be to establish the right framework conditions and incentives. Our intentions are good, but we have difficulty putting them into practice. The author and economist Hanno Beck described this predicament with the following words: "Whether we want to cut down on calories, stop smoking, make provision for retirement or take up sport – the decision we make today all too often falls prey to the weaknesses of tomorrow."

One way of overcoming this time inconsistency is to establish a realistic commitment device. We find a classic commitment device in one of the tales of Ulysses, who wanted to hear the song of the Sirens. Knowing full well the dangers that entailed, he had himself tied to the mast of his ship, had his sailors stuff their ears with wax and ordered them not to untie him, no matter how hard he pleaded.

Commitment devices are useful ways of resisting dangerous temptations in economic policy, too, although the perils may not be quite as dramatic as those Ulysses faced. The independence of the central banks and the focus of their mandate on price stability is an excellent example. The fiscal rules of the Stability and Growth Pact are another, even if the extent of their success is open to dispute.

However, time inconsistency is only one of the reasons why decision makers sometimes find it difficult, when they make their decision, to choose what will be right in the long run.

2. Economic policy challenges

And this brings me to the challenges that Germany will have to cope with in the medium to long term. Germany is doing comparatively well – partly because of the reforms of the past decade. It has a balanced government budget, low unemployment and a high level of competitiveness. However, there are no grounds for complacency, particularly as Germany is faring well in many areas only in relative terms, which is to say relative to other countries which are currently burdened by great difficulties.

Advancing globalisation, shifts in energy policy, high government debt and the ageing of the population will present challenges to Germany, as well – perhaps to Germany in particular – even if the current crisis and its burdens are rapidly overcome.

Ladies and gentlemen, ten years ago Germany was referred to as the "sick man of Europe", a sobriquet given by the Economist magazine. At that time, the economic situation Germany found itself in prompted the Bundesbank, in a paper entitled Ways out of the crisis, to write,

"Germany has fallen far behind European partner countries in terms of key data such as GDP growth, employment and the government deficit."

Far-reaching reforms were initiated in Germany to tackle this period of structural weakness. Among them was the Agenda 2010 reform programme, which included the so-called "Hartz IV" legislation. Moreover, in view of the location-related problems that key industries faced and the high level of entrenched unemployment at that time, the wage bargaining partners steered a course of wage moderation over a prolonged period of time.

Both of these measures helped improve the situation on the German labour market significantly. The number of persons in work has risen by three million since 2005 and now stands at an all-time high. The number of registered unemployed has fallen from almost five million in 2005 to less than three million today. And the average duration of unemployment has declined sharply. This has played a part in Germany's becoming the anchor of stability in the euro area.

Looking forward, however, it quickly becomes clear that the healthy condition of the German economy is certainly not assured on a long-term basis. Disregarding migration effects for the moment, there will be one-and-a-half million people fewer on the labour market in 2020. That is a decline of 2.5%. In 2020, economic output will thus be nearly €70 billion lower than it would be without this demographic effect.

According to estimates by the OECD in its report entitled "Looking to 2060", Germany will post the second slowest growth of all 42 countries in the study by 2030, and the slowest growth by 2060 – mainly owing to demographic trends. The prospects for per capita growth, which is a crucial driver of prosperity, look somewhat better because of the falling population. However, here too, Germany will only occupy a mid-table position in Europe, according to the OECD. What is more, weak economic growth will also have a negative impact on, for instance, the country's innovation and adjustment capacities.

There are two ways to combat this deceleration of economic momentum – either by increasing the number of persons who work or by increasing the productivity of those who work. To increase the number of those who work we can raise labour force participation among women and older people, and we can further increase the influx of labour from abroad, given that employment in Germany recently reached a new all-time high largely due to immigration. That is why a systematic approach to attract foreign labour whose skills we need here would represent a major contribution towards helping cushion the impact of an ageing society on the labour market.

In addition, a further expansion of childcare and care for the elderly could improve options for women in particular to take up or increase their paid employment. However, the present system of taxes and transfers can, in some cases, stand in the way of higher labour force participation. For example, non-contributory inclusion in statutory health insurance makes having a job less worthwhile.

On the other hand, these instruments are being used to pursue other political objectives which have to be weighed against the employment effect. Only policy makers can find the balance. My point is to remind people that these measures make it less attractive to take on paid employment and can therefore cost us growth. This is a price we need to be aware of.

No matter how policy makers and society at large decide, a better work-family balance on its own is not enough to maintain, far less to increase, economic strength in an ageing society. It is just as important that we do not surrender any of the progress that has already been achieved on the labour market.

This applies, in particular, to the current debate on the wider application of minimum wages. Opinions are divided on whether minimum wages increase unemployment. That depends decisively on the size of the wage and the other components of the framework, such as the social safety net for unemployment and job protection.

In 2007, the economists David Neumark and William Wascher took stock of the status of research on minimum wages by looking at 102 individual studies. Two-thirds of the studies examined suggest that minimum wages have a negative impact on employment. The 33 studies which, in their view, were sound in terms of their methodology conclude that the effects on employment are very predominantly negative. Furthermore, it is shown that binding minimum wages affect the low-skilled and the long-term unemployed to a particular extent.

The high youth unemployment levels in the crisis-hit countries in the south of the euro area are partly attributable to minimum wages. This is because, even if a minimum wage does not affect unemployment directly, it may still have a negative impact on employment dynamics. There is a risk that enterprises will hire fewer new staff in periods of economic upturn. And that primarily affects those sections of the labour market that a minimum wage would actually be intended to help. Thus, there is a danger that the minimum wage may have the opposite effect to the one intended.

According to recent surveys, 83% of Germans are in favour of introducing a blanket minimum wage. But in this question, too, it has to be said that, however policy makers and society decide, they need to be aware of the economic risks to employment in Germany that this entails. These risks will be higher, the more a minimum wage is prescribed in employment contracts. That, in turn, would depend on the amount of such a minimum wage and on whether any differences were made between eastern and western Germany or young and old employees.

Of course, the fortunes of German economic performance are not shaped on the labour market alone. Action needs to be taken in other areas, too; education policy is certainly one of them. If, in future, fewer workers will be at our disposal, it is all the more important for them to have the best possible qualifications. Energy policy is another such area. We also need an effective infrastructure. And another area I would like to mention is tax policy – and here, in particular, corporate tax laws. It would be a significant step forward if a financing-neutral tax system were introduced which affords equal treatment to corporate profits instead of giving preferential treatment to debt financing.

3. The right framework for monetary union

Ladies and gentlemen, some may not consider Germany's challenges to be particularly pressing at first glance. This inevitably makes it more tempting to postpone politically uncomfortable decisions or to revoke decisions which are controversial but economically necessary.

The euro area is not an island – we are in competition with countries like the United States and Japan. Little would be gained from getting the crisis countries back on track to growth thanks to successful reforms only to find that the largest member state had lost steam. It is not merely about shifting competitiveness within the euro area. The euro area as a whole needs to become more competitive.

To put an end to the crisis in the euro area once and for all, we need to address the weaknesses and false incentives which led to its onset in the first place. All 17 euro-area countries are governed by a single monetary and foreign exchange policy. Yet each member state determines its own national economic and, above all, fiscal policy.

This arrangement further compounds the tendency of governments to finance government spending through debt. This is because part of the cost of additional debt can be passed on to other countries. And, as we have seen over the course of the crisis, excessive debt can put pressure on monetary policy to plug fiscal gaps by printing money.

Institutional arrangements, such as the Stability and Growth Pact and the no bail-out clause, were, of course, put in place to prevent a build-up of excessive debt by member states. Unfortunately, however, these fiscal rules lacked the necessary punch, not least because

they led to a situation in which potential sinners were passing judgment on fellow sinners, to paraphrase Otmar Issing.

It was hoped that the financial markets would have a disciplining effect, but this, too, proved not to be the case. For many years, Greece was highly indebted, but paid little more for its debt than Germany or France. It seems that investors simply couldn't imagine that the other member states would allow one of the euro-area countries to default – and they weren't entirely wrong about that, as we now know.

One reason for this was probably that the international capital rules adopted in the early 1990s allow banks to treat government bonds in their domestic currency as a risk-free investment requiring no capital backing. This applied regardless of how risky financial market investors considered the bonds to be or how bad the fundamentals really were. Of course, this regulatory treatment not only encouraged banks to buy government bonds, it also stopped the no bail-out clause from being taken that seriously.

Although the founding fathers of monetary union provided for the risk of undesirable fiscal developments, no corresponding institutional arrangements were made for other factors, such as the erosion of competitiveness or excesses in the financial sector.

That was fine for a while, but the shortcomings at a national level became increasingly apparent when the global credit bubble burst. A number of euro-area countries were pushed to the brink of insolvency by the crisis. This gave rise to significant risks to financial stability in the euro area, particularly as it became clear just how quickly the effects can spread from one vulnerable country to another.

The bailout funds helped to stabilise the euro area, but did not address the underlying problems. What's more, the very existence of the bailout fund creates new false incentives. That is why I am in favour of using it only as a last resort and advocate structuring the conditions in such a way that countries are not encouraged to take advantage of them.

In effect, however, the numerous crisis measures increased mutual liability within the euro area without establishing any sufficiently effective control rights in return. This upset the balance between liability and control. This balance must be restored to safeguard the long-term stability of monetary union.

One option for redressing the balance would be to make greater mutual liability conditional on greater mutual control. The member states would ultimately have to be prepared to relinquish national sovereign rights to the European level and thus combine the existing monetary union with a fiscal union. This echoes the sentiment of Bundesbank President Karl Blessing, who in 1963 said that: "A common currency and a federal central banking system are feasible only if, apart from a common trade policy, there is also a common fiscal and budgetary policy, a common economic policy, a common social and wage policy – a common policy all around."

In my opinion, however, such a far-reaching transfer of national sovereignty to the European level requires the backing of both policy makers and the public at large. There was no such support when the monetary union was created and little has changed since. In the midst of the crisis, I do not see sufficient willingness on the part of EU governments or citizens – neither in Germany nor elsewhere – to actually transfer sovereign rights on budget issues to the European level.

Merely increasing mutual liability – by introducing eurobonds, for example – without establishing greater mutual control in return, would only provide additional incentive to incur debt. After all, you wouldn't entrust your credit card to someone if you weren't able to control their spending.

For the time being, therefore, the only answer to the crisis is to strengthen the Maastricht framework. In doing so, more needs to be done to render the fiscal rules more binding – rules which have too often been stretched and ignored in the past. New agreements, such as

the revised Stability and Growth Pact and the Fiscal Compact, are steps in the right direction in this regard. However, it is vital that the new rules are applied in actual practice rather than existing only on paper.

But the essence of a strengthened Maastricht framework is that member states be held responsible for the consequences of their financial policy decisions. In this connection, it must also be possible – as a last resort – to declare governments insolvent without endangering the stability of the European financial system as a whole.

To improve financial stability, the heads of state and government in euro-area countries have agreed to establish a European banking union. If implemented properly, this banking union can rectify deficiencies in competition in the banking sector through a strict single European supervisory mechanism. With an appropriate recovery and resolution regime, it can also strengthen the disciplinary effect which capital markets have on governments.

The banking union once again puts the focus more squarely on the principle of liability. However, regulation must also be adapted if the vicious circle of reeling states and struggling banks is to be broken and not simply passed onto the European level. After all, as I have already mentioned, government solvency problems have hit the banking sector head on until now at the risk of triggering a financial crisis. This is because banks are not required to hold capital backing for investments in government bonds. And, unlike loans to enterprises, there is no upper limit for loans to a particular government.

That is why, over a medium-term horizon, government bonds should be treated just like other bonds or loans to enterprises. Obviously, new regulations such as these require appropriate transition periods so as not to further exacerbate the funding problems that some countries are experiencing. However, they are essential in ensuring that governments bear more responsibility for their own decisions in future and should therefore be adopted as quickly as possible.

In the long term, it must be possible to declare both governments and large banks insolvent without endangering the financial system or without taxpayers having to foot the bill. Providing the right incentives is therefore not only important for fiscal and economic policy decision-making processes; it is also the key challenge for financial market reform.

Here, too, the aim must be to ensure that banks and their investors once again bear responsibility for their own actions. With the implementation of Basel III, banks will have to hold more and better-quality capital to better absorb losses. It is also important that if a credit institution needs to be restructured or wound up, its owners and creditors bear a fair share of the losses. As I have mentioned, this will be the job of the European recovery and resolution mechanism. However, the current proposals for creditor involvement still allow for too many exceptions. This runs contrary to the principle of market discipline and should be addressed in the course of the legislative process.

In addition to resolution regimes, shadow banking is another particularly important topic at a global level. The specific recommendations for regulation and the clear schedule agreed at the recent G20 summit in St Petersburg were a definite step forward in this regard.

Progress is therefore being made in the regulation of financial markets, both at an European and a global level. But a great deal remains to be done to ensure the individual elements come together to form a cohesive system.

4. Summary

Ladies and gentlemen

Despite imbalances, Germany is now in better shape than it was ten years ago. It is no longer the "sick man" of Europe. That said, we should not forget that adjustments will always be necessary to safeguard prosperity. This is especially true for the European crisis states.

But more is required to ensure that monetary union can once again function properly as a whole. From now on, it must not be possible for the problems of individual countries or banks to jeopardise the entire system. An operational framework which reinforces the principle of liability and reduces mutual dependencies brings us a good deal closer to achieving this goal.

I would like to thank you for your attention today – but, then, this is something I have always been pleased to receive in Darmstadt.

I am now very much looking forward to our discussion!