Jens Weidmann: Independent, stability-oriented central banks are the main anchor of confidence

Opening speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Deutsche Bundesbank's second cash symposium, Frankfurt am Main, 19 May 2014.

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1. Introduction: unbacked currencies need anchor of confidence

Ladies and gentlemen, the Austrian poet Johann Nepomuk Nestroy is once said to have wittily remarked: "The Phoenicians invented money – but why so little?"

I cannot guarantee that we will have come up with an answer to this question by the end of the day. However, what I can say is that I am pleased to open today's event and therefore wish to welcome you warmly to the Bundesbank's cash symposium. It is the second of its kind – the first was held in 2012 – and is intended to promote professional and personal exchange between the various cash handlers.

The professional activities of most of the people in attendance here today revolve around cash. However, cash naturally accompanies the everyday lives of you as individuals as well as the general public – for it is one of the few things that nearly everyone is likely to have on his or her person at all times. Sometimes more, sometimes less, but at least enough so as never to be completely out of money.

Cash not only continues to be the most popular and widely used medium of payment for shopping in Germany, but is also a central bank's most visible "product". Banknotes and coins have a concrete touch and feel to them and are physically tangible, which is not the case with other "central bank products" – such as monetary stability.

Ladies and gentlemen, in his satirical essay "Brief Outline of the National Economy" published in 1931, Kurt Tucholsky noted sarcastically that "Where money comes from is unknown. It is there, or not – mostly not." The fact that banknotes are now almost always issued by central banks and circulated through commercial banks is easy enough for the average citizen to understand. But that does not exhaustively describe central banks' role in the cash cycle by any means.

In order to understand this role, it is important to also answer the more fundamental question of what exactly money is. In economics terms, the shortest possible answer to this question is that money is what money does. All sorts of objects can function as money if they can be used as a unit of account, a medium of payment and a store of value

And a stroll through the history of money yields plenty of examples. Throughout the various cultures, objects as different as cowrie shells in the South Seas, arrowheads and gold powder in Japan and, of course, coins, which were first struck by the Lydians in Asia Minor around 700 BC, have served as money.

Even today, coins remain part of our cash. As do banknotes, which, for their part, became accepted as a form of payment only in the 19th century. Earlier attempts to install paper money generally quickly turned into a fiasco. Too much money was printed; paper money was then no longer accepted.

Today, coins and notes are the sole legal tender. This means that, in legal terms, their acceptance is mandatory provided the parties to the contract have not expressly agreed any other form of payment.

In the real world, the acceptance of cash in daily economic transactions, however, is not based on this legal obligation. This is clear when we remember that, even in periods of runaway inflation, the acceptance of domestic notes and coins was mandatory, too. In such times, however, many people resorted time and again to alternatives, replacing inflationary money with other payment media considered more valuable for everyday transactions.

Today's exchange of goods based on monetary payment is therefore based, first and foremost, on confidence among the public that they can use the money obtained – which, in the case of banknotes, means pieces of printed paper – to make purchases themselves. The functional viability of a currency therefore hinges on public confidence in the value of the money.

Independent, stability-oriented central banks are the main anchor of confidence. This works in two ways. One is that central banks need to ensure that the currency issued cannot be reproduced at will by anyone – that it is as counterfeit-proof as possible and therefore always genuine. The other is that central banks maintain the currency's purchasing power. The success of such a policy hinges crucially on the central bank's credibility as a guarantor of stable money.

2. Confidence likewise essential to overcoming euro-area crisis

2.1 Euro-area crisis is fundamentally a crisis of confidence

The stability of our currency, the euro, depends not just on public confidence in the Eurosystem's stability orientation but also on conditions which the Eurosystem cannot itself create. These conditions include healthy government finances, competitive member states and a well-functioning regulatory framework.

With regard to the confidence aspect, the extreme escalation of the situation in the government bond markets observed in the summer of 2012 ultimately reflected massively shaken confidence in the sustainability of various member states' government debt. The sovereign debt crisis is therefore, at the core, a crisis of confidence.

In terms of market indicators – such as the yields on government bonds or yield spreads over investments regarded as safe – much of the severe damage to confidence seems to have been repaired. However, it is too early to declare the crisis over. The very high unemployment rates in many of the crisis-stricken countries, sadly, tell an entirely different story.

In this context, we have to be aware that the structural problems at the root of the crisis built up over the space of many years. Accordingly, not only considerable effort but also much stamina will be necessary to surmount these problems, and thus the crisis, over the long haul. Metaphorically speaking, the actual solution to the crisis is akin to a marathon, and not to a sprint. Although a considerable portion of the entire course has already been covered, the finish line is still quite a ways ahead.

It is precisely the crisis countries that need to commit to using the improvement in the financial markets to make further decisive progress along the road of consolidation and reform and not, for instance, to stop and take a breather.

Given the depressingly high unemployment rate in the countries particularly hard-hit by the crisis, it is necessary to keep working on developing the foundations needed for robust growth and sustained employment gains. This includes measures to improve the investment climate and to make the labour market more flexible. In addition, the weaknesses in the banking system need to be fixed. Moreover, there is a need for many member states to take action with regard to public finances.

2.2 Reinvigorating confidence in fiscal policy

The reinforced fiscal rules of the Stability and Growth Pact are a key anchor with which to keep fiscal policy in all member states on a sustainable path of stability and growth. The objective must be to make these rules more binding in future and thus more effective than they had been before the sovereign debt crisis.

In view of some critical comments, one cannot emphasise often enough that the Stability and Growth Pact in monetary union is by no means an end in itself, but follows a distinct logic.

The stability pact takes account of two factors. For one, it reflects the economic knowledge that a stability-oriented monetary policy has to be complemented by a fiscal policy that is similarly oriented to stability in order to be successful in the long run. After all, experience shows that political pressure on central banks regularly rises in line with public debt levels. The aim of such pressure is to mitigate the burden of public debt through lower interest rates.

However, a monetary policy that is oriented to government's funding needs and not to monetary stability can lead to higher inflation sooner or later. Higher inflation, though, is always at the expense of those who are least able to escape from it. To be more concrete: the cost of accelerating inflation is particularly borne by ordinary people.

The other factor is that the Stability and Growth Pact takes account of the particular principle of the structure of monetary union that national fiscal policy has remained the responsibility of the individual member states whereas the single monetary policy, naturally, is decided by a central body.

This union of decentralised fiscal policy and single monetary policy entails the risk of unwelcome developments in individual countries' public finances weighing on the single monetary policy and at the same time imposing a financial burden on the other member states. In a monetary union, there is, so to speak, an "inbuilt" incentive of sorts to run up excessive debt. This incentive derives from the fact that one country can partially pass on the adverse effects of its unsound fiscal policy to the other member states. The interest rate rise that accompanies the borrowing has a less severe impact on the highly indebted country than would be the case without monetary union. The experience of the past few years has certainly shown in all clarity that the risks of excessive indebtedness are not just theoretical in nature.

In order, above all, to counteract this risk, the fiscal rules contained in the stability pact represent an inherent stability-policy pillar of monetary union: a pillar which, over the medium-term, creates the conditions not only for monetary stability, but also for economic prosperity. Over the medium and long run, sound government budgets and economic growth, in fact, are not mutually exclusive – quite the contrary.

The European Commission, as the guardian of the treaties, will assume a key role in ensuring that the euro-area member states stick to the fiscal policy path of conformity with stability. However, it is at least as important for each and every individual member state to be aware of the value of sound public finances and to behave accordingly – especially also with an awareness of responsibility for the stability of the monetary union as a whole.

All countries are being called upon here, but particularly the large countries. Their behaviour sends a strong signal, and they therefore have to be aware of their particular responsibility and also act accordingly. The restoration of compliance with the provisions of the Stability and Growth Pact must not be permitted to become a target which is put off ad infinitum. Fiscal consolidation agreements need to be adhered to.

This has nothing to do with a "saving or austerity dogma" but simply reflects the fact that lasting confidence in fiscal policy is hard-won and needs to be defended time and again.

The disciplining effect of the capital markets for fiscal policy will be an important factor. In the past, the capital markets have not always exercised this function to the fullest. This, too, was revealed by the crisis. It is therefore important to reinforce the principle of independent fiscal policy responsibility built into the founding architecture of monetary union. Those who have control over fiscal policy decisions also need to bear the consequences. That is the only way to ensure sound public finances, especially in monetary union.

3. On the current exchange rate discussion

Ladies and gentlemen, public debate has recently also been permeated by another topic: the euro's exchange rate. In this connection, one can increasingly hear calls for monetary policymakers to take on a more active role with regard to exchange rates. This is associated with the desire for monetary policymakers to, wherever possible, ensure that the euro's external value is maintained at a level regarded as appropriate and, if need be, to act decisively to avert a potential further appreciation.

As we know, such debate and the attendant demands are not new. These are mostly based on the idea of using monetary policy means to devalue a country's own currency in order to promote growth and employment.

In order to strengthen growth and employment in the euro area over the long run, however, the member states will have to ensure competitive economic structures. Put loosely, the exchange rate is like the well-known peppermint drops from the packet: "If they're too strong, you're too weak."

Since the beginning of monetary union, euro-area monetary policy has been primarily geared to maintaining the currency's purchasing power – and for good reason. The euro's exchange rate, however, is not an objective of the single monetary policy. After all, an exchange rate target could very well come into conflict with the price stability mandate. All parties who are now raising the spectre of political exchange-rate targets need to be aware of this.

In addition, a unilateral focus on exchange rates would also be difficult to conceive for the monetary policy of a large currency area, as targeted devaluation of the domestic currency could always trigger opposite reactions from other currency areas. This would end up leaving all countries involved worse off than before.

However, the exchange rate – like other economic factors – is relevant to the Eurosystem's monetary policy inasmuch as exchange rate movements can impact on the movement of price levels within the single currency area.

We are currently in the midst of a period of exceptionally low inflation in the euro area, which will probably last for some time to come. The ECB Governing Council will therefore also observe further exchange rate developments very carefully in its monetary policy decisions.

In light of the public debate about the movement of the euro's exchange rate, we must not overlook the fact that interest rates in government bond markets in the euro-area member states have dropped again considerably in the past few weeks. One of the factors behind this development seems to be that international investors are shifting their investment portfolios and increasingly returning their funds to euro-area countries. This also appears to include investments precisely in those countries hit particularly hard by the crisis.

This change in capital investment patterns appears to have contributed to the rise in the euro's external value while at the same time perceptibly easing funding conditions. The short-term dampening impact of a currency appreciation is offset by the positive growth effect created by more favourable funding conditions. Over the medium to long term, the expansionary funding impact is likely to prevail. It would therefore be short-sighted to look only at exchange rate movements without taking into account the stimulating impacts of falling government bond yields.

Ladies and gentlemen, I, too, would like to take something into account: the time schedule. I have spoken a lot about confidence. I am therefore confident that you will forgive me if I've exceeded my allotted time limit somewhat. I hope you all have a successful symposium, in which you will obtain new knowledge from the various talks and have a lively exchange of information and opinions at the panel discussions.