Jens Weidmann: Heading for stability and prosperity – bringing the euro area back on track

Keynote speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the City of London Corporation, London, 12 February 2015.

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1. Introduction

Lord Mayor

Ladies and gentlemen

I am very pleased and honoured to speak here at the Guildhall today, so thank you for the invitation.

I do not always agree with the Financial Times' chief economics commentator Martin Wolf, but he was absolutely right when he wrote in one of his recent commentaries: "These are exciting times in European central banking." Indeed, they are. The excitement is due, not least, to the controversial decisions that have been taken recently.

I would like to seize this opportunity to explain to you my view on current monetary policy issues, although I also wish to talk about the future of European monetary union (EMU).

2. "Masters of the Universe"

Ladies and gentlemen

The first time I heard the expression "Masters of the Universe" was in the early 1980s when the action toy figures of the same name conquered toy markets worldwide. By 1986, sales had ballooned to USD 400 million before plunging to a mere USD 7 million just one year later: the strong and virtuous He-Man and his sidekicks took a fall and never recovered.

In the same year as those figures vanished from the toy shops, a bestselling novel by Tom Wolfe took the book stores by storm: The Bonfire of the Vanities. The slightly unsavoury hero of the story, a fixed-income broker on Wall Street, and his colleagues in the bond department considered themselves to be the very "Masters of the Universe".

Since then, the members of the toughest and most sophisticated business areas of the financial sector have frequently been referred to as "Masters of the Universe".

Since the global financial crisis, however, the reputation of the financial industry has been seriously tarnished, above all in the public eye. While many were certainly to blame for the crisis, it became obvious that insufficient financial market regulation and wrong incentives in the financial system, for example in remuneration, contributed significantly to the crisis.

When the financial system was on the brink, governments and central banks had to step in to maintain financial stability and protect the real economy from negative spill-overs.

In normal times, central banks do their business without attracting very much attention from the public, and rightly so – you may remember Mervyn King's characterisation of a good central banker: "Boring is best".

But in times of crisis, central banks move into the focus of attention. Over the past few years, however, expectations as to what central banks can do and should do have reached excessive levels. No wonder central bankers are today considered to be the new or the real "Masters of the Universe".

As you can probably imagine, I refuse to accept this label. The higher the expectations placed on central banks' abilities, the greater the risk of overburdening them.

This problem is particularly relevant in the euro area, where the ECB is considered by some to be the only workable institution. However, I agree with my French colleague Christian Noyer who recently said: "It's not good to be seen as 'the only game in town' (…). We cannot substitute governments just because their response is believed to be too slow."

3. Current monetary policy in the euro area

The main firewall against overburdening is the central bank's mandate: which is why central banks should stick to it. In the case of the Eurosystem, the mandate enshrined in the EU Treaties is to maintain price stability in the euro area. The Governing Council aims to maintain inflation rates "below, but close to, 2% over the medium term".

At the current end, inflation rates in the euro area are significantly below 2%; in fact, the most recent inflation figures were negative. Without doubt, this puts the Governing Council in quite an uncomfortable situation. It is clear that an excessively prolonged period of low inflation – or "lowflation", to use the IMF's expression – is not harmless: It could put a strain on the sustainability of private and public debt in some countries and make the economic adjustment process in countries with losses in competitiveness more difficult. However, it is worth underscoring that this is an admissible argument in monetary policy discussions only insofar as it impacts on price development over the policy-relevant horizon.

And I am quite sure that for most of you, it was quite clear that the Governing Council had to react – and that the Governing Council decision three weeks ago to launch a sovereign bond purchase programme, or QE, was the only logical response.

The question you have presumably been asking yourselves is this: why the ongoing discussion in the Council about a monetary policy instrument that other central banks have used successfully in the past? The answer is, because government bond purchases in a monetary union with a single monetary policy and 19 independent fiscal policies are not an instrument like any other. They have risks and unintended side-effects which could – and indeed do, in my view – outweigh their expected impact.

As you know, I am sceptical about the decision on the government bond purchase programme. But take it from me, this scepticism is not founded on what some see as chronic Bundesbank naysaying to a loosening of monetary policy; rather, it is the outcome of a difficult process of weighing the pros and cons of QE.

While I acknowledge the difficult situation facing the Governing Council, and while I have backed many of the previous measures taken to enhance monetary accommodation in the euro area, in my view there was no immediate need for this particular measure. What we are currently seeing is a disinflationary process, not a deflationary spiral of decreasing prices and wages. The risk of self-reinforcing deflation is still considered to be very low. And this is not only my assessment, but that of most other Governing Council members, too.

One of the main drivers of disinflation is the sharp fall in energy prices, a factor that is expected to be transitory in nature. Hence, all the economic forecasts predict that inflation rates will rise over the medium term, albeit at a rather sluggish pace.

The decline in oil prices works more like an economic stimulus for the euro area than a harbinger of imminent deflation, as the lower oil price reduces the energy bills of both households and businesses. It therefore frees up financial resources which can then be put to use elsewhere – for consumption, investment or for reducing debt. All of this is good for the economies of the euro-area countries.

Without any signs of second-round effects – and I do not see any – monetary policy need not take any steps to counter the potentially short-lived effect of lower oil prices on consumer prices. With regard to per capita employee compensation in 2015, the European Commission forecasts a euro-area increase of 1.3% – and even in a country like Spain, with its protracted negative inflation rate, the increase is expected to be 0.7%. And in Germany, with its growth above potential and its high level of capacity utilisation, an increase in per capita employee compensation of 2.9% is expected.

But it was not primarily my assessment of the need for action which made me sceptical about QE, but more the combination of the need and the instrument at hand – government bond purchases.

I do not expect QE to have no impact on inflation. But the effects are difficult to gauge, and it can be assumed that they will be weaker than in the US, for example, because interest rates in the euro area today are already much lower than in the US, especially when the first QE programme was launched. Moreover, the funding of US companies is much more capital market-based than that of European businesses, and wealth effects are generally smaller, too.

And government bond purchases involve the fundamental risk of mutualising sovereign liability risks via the central bank's balance sheet. While this risk can be more or less ignored for countries with their own currency, it can be a major problem for a monetary union – especially so for one which, like the European monetary union, is not a fiscal union.

At the end of the day, it could introduce common liability through the back door. And in this regard, I am a guy who prefers to use the front door. That is to say that it's up to elected governments and parliaments to make such far-reaching decisions.

I do acknowledge that the adopted sovereign bond purchase programme partly takes into account some of the concerns related to earlier programmes: Only a small part of the programme is subject to risk sharing among the central banks of the Eurosystem. Additionally, the Governing Council decided on limits for the Eurosystem's purchases of individual bond issues and for its overall purchases of debt of one single country. This is designed to ensure that governments continue to rely on the capital markets for their funding.

Despite all these measures, which obviously make the QE programme less problematic than earlier sovereign bond purchase programmes which aimed to reduce the risk premia of individual countries, one important risk nonetheless remains: The national central banks will become the most important creditors to their governments, which might ultimately put the independence of monetary policy at risk. The purchases will make life easier for finance ministers. They will not be amused when the Governing Council considers exiting its ultra-loose monetary policy. And they might be tempted to put political pressure on the Eurosystem. In the European monetary union, however, fiscal discipline is absolutely essential because the set-up of the monetary union can further compound the tendency of governments to finance their spending through debt, as the consequences of bad policy choices can more easily be externalised to neighbouring countries.

Finally, I am worried that sovereign bond purchases will undermine structural reforms and budget consolidation in euro-area countries – especially if the impression were to emerge that the central bank is stepping in to take the place of effective policy action

time and again. Structural reforms and sound public finances, however, are essential if the euro-area crisis is to be overcome.

Certainly, structural problems cannot be resolved by printing money. The Eurosystem has played a significant role in preventing an escalation of the crisis. However, central bank action cannot replace the necessary adjustment processes. In this regard, I appreciate assurances by European leaders to the effect that QE must not substitute structural reforms. However, I have to admit that they made me think of a famous quotation from Goethe's Faust:

> Die Botschaft hör ich wohl, allein mir fehlt der Glaube –
>
> I hear the message well, but lack Faith's constant trust.

4. The future of EMU

Ladies and gentlemen

Although the media and others often refer to it, for brevity's sake, as the "euro crisis", it is not actually a currency crisis but elements of a debt crisis, banking crisis and balance of payments crisis all rolled into one.

This cocktail of crises laid bare unfavourable developments in several countries in the first decade of EMU. Economies which had significantly higher interest rates before the euro saw strong capital inflows following the introduction of the single currency. Unfortunately, these funds flooded into private or public consumption or into an oversized housing sector.

It was in connection with exaggerated growth expectations, a decrease in competitiveness caused by high wage settlements, as well as insufficient financial regulation, that considerable imbalances built up. These then contributed to the financial, economic and – later – sovereign debt crises.

The crisis also revealed shortcomings in the institutional design of EMU. One could say that the EMU framework was not built to withstand adverse weather conditions.

When the storm came, measures had to be taken quickly to stabilise the monetary union and its financial system. However, those measures have thrown the balance between liability and control out of kilter, because liabilities have been partially mutualised while fiscal decision-making has essentially remained national.

In order to overcome the euro-area crisis once and for all, three things have to be done.

1. The adjustment process at the national level needs to be continued.
2. The institutional framework of EMU needs further reform.
3. The financial system needs even greater resilience.

Let me elaborate on the three items on this agenda.

4.1 National adjustment process to be continued

The adjustment efforts have made considerable progress over the past few years. Most of the crisis-hit countries have managed to substantially diminish their structural budget deficits. In addition, the current account deficits have largely been reduced.

Price competitiveness in the crisis-hit countries has also seen significant improvement. Measured in terms of the deflators of total sales the competitiveness of the economy has improved by 6% in Portugal, 9% in Spain and 12% in Ireland. The competitiveness of the Greek economy has risen by as much as 14%. To some extent, these figures can be attributed to the depreciation of the euro. Nevertheless, the figures for the

countries I have just mentioned are also positive when measured in terms of the euro area.

Needless to say, the job has not been finished yet. Structural reforms have been implemented, but more needs to be done.

Structural reforms are the best way to generate sustainable economic growth and create employment. It is becoming increasingly clear that the efforts are bearing fruit: unemployment rates seem to have peaked, and the economies are growing again.

This makes it all the more important for the achievements not to be compromised.

The risk of a backlash is particularly high in Greece. However, I firmly believe that it is also in Greece's own interest to do what is necessary to tackle the structural and fiscal problems it is facing. Greece will continue to need support, but support can only be given if the agreements made are complied with. Incidentally, Greece's debt ratio is very high, but the average maturity is quite long and the average interest rate quite low – as is the current annual level of debt servicing. Hence, further debt relief would not really change Greece's liquidity situation by much. But any further relaxation of the agreed targets would be counter-productive to efforts to regain investors' confidence in Greece's debt sustainability. And that would come at the expense of taxpayers in other euro-area countries. Additionally, it would also be to the detriment of other euro-area countries' governments: it would be much harder for them to justify the rocky path of economic reform.

But at the end of the day, there is no alternative to economic reforms in the euro area – and to reforming the EMU framework.

4.2 Reform of the EMU framework

Concerning the long-term reform of the EMU framework, the primary objective should be to increase the incentives to make sound and responsible decisions within the euro area. To this end, it is important to rebalance liability and control.

Either we establish centralised rights to intervene in national fiscal policies or we strengthen the principle of individual national liability.

The first option would imply a kind of fiscal union, that is to say a significant shift of fiscal sovereignty to Brussels.

In this regard, Governor Carney in his recent Dublin Lecture explicitly called for "common fiscal arrangements" in the euro area. Without such risk sharing, which he considers effective in federal systems like the US, Canada or Germany, the euro area would, he said, find itself "in an odd position". In the UK, he pointed out, Scotland would have been hit much harder by the recent fall in oil prices if it were not in a fiscal union with the rest of the UK. However, these federations and the UK, too, have a powerful centre, whereas the euro area consists of 19 independent nations. A central fiscal stabiliser would require central intervention and control rights. Otherwise the path would be set towards a transfer union, and that is certainly not the way to a prosperous union.

A transfer union would be a disincentive to keeping public finances in order, and persistent transfers in one direction could undermine political acceptance of EMU.

The decision by the newly elected Greek government to stop cooperating with the Troika shows how unpopular sharing sovereignty rights with foreign creditors is, even in cases in which national expenditures are largely dependent on external financial help.

In a nutshell, I do not see enough support for such a great leap forward – either in the political sphere or among electorates – which is why I do not expect it to occur in the

foreseeable future. That's why the principle of national liability needs to be underscored. Otherwise, the deficit bias of member states of the euro area will be strengthened, which is harmful to the stability of the currency union.

Reform steps taken since the onset of the euro-area crisis have largely moved in the right direction. However, it is not enough to strengthen the fiscal rules; these rules also need to be strictly applied.

The greater emphasis that has recently been placed on the notion of "flexibility", and the European Commission's comments four weeks ago regarding its future interpretation of the fiscal rules give reason to fear for the binding effect of the rules.

Relying on fiscal rules alone will not help to overcome the euro area's vulnerability to crises once and for all. On the contrary, additional steps are needed to strengthen the disciplining effect of capital markets on fiscal policy. In that sense, the principle of individual national responsibility ultimately means that governments, too, must be allowed to fail financially.

4.3 Making the financial system more resilient and effective

Sovereign default, however, is still a tricky issue where financial stability is concerned. Making the financial system more resilient, and banks less vulnerable, is therefore the third item on the "to do list" to bring the euro area back on track. This, by the way, is not a challenge exclusive to the euro area, although it is particularly relevant there.

In a comment piece published in the Financial Times about a year ago, Tim Harford wondered: "Why can't banking be more like baking?" Referring to the Great Fire of London almost 350 years ago, he wrote: "The last time a baker laid waste to the City was 1666 […]; bankers seem to be able to perform the trick more frequently." Despite the similarity in spelling there are, of course, significant differences between those two lines of business which explain, for example, why we need a European banking union but not a baking union in terms of a single trade supervision for bread makers, say. Systemic importance, the "too big to fail" issue, and information asymmetries are just a few of the special features that distinguish the financial sector from non-financial business areas.

The financial crisis laid bare that banking regulation – or metaphorically speaking: the fire protection – had been insufficient. This was a key lesson learned from the crisis, and the regulations have been tightened over the past few years.

However, the regulatory agenda has not been completed. In order to prevent too much business from being shifted from the regulated banking sector to the unregulated shadow banking sector, we need to adequately regulate the latter as well.

As I have already said, financial reform is of particular relevance for the euro area – the financial system turned out to be the Achilles' heel of monetary union.

The introduction of the single currency led to financial integration, but the focus of regulation remained primarily national. Hence, the lack of a banking union was a shortcoming of the monetary union.

The establishment of the banking union, including a Single Supervisory Mechanism based at the ECB and a Single Resolution Mechanism for ailing banks, is a key step towards making monetary union more stable in the long term.

European banking supervision and the single rule book counteract regulatory arbitrage and regulatory capture. And as Governor Carney said last year in Davos: "To make the system fairer, the days when banks privatised gains but socialised losses must end." The bail-in procedures which kick in if a bank fails, and which will take effect from the start of 2016, will help preserve taxpayers' money. It was not fair to have taxpayers bail out creditors of distressed banks, and it reinforced the moral hazard problems of too-

big-too-fail. But it was widely regarded as a necessary evil for the sake of financial stability given the unclear rules on liability.

While the banking union will help to protect governments from the fate of banks, it will do little to protect banks from the fate of governments. Hence, the banking union will not suffice to sever the disastrous sovereign-banking nexus which acted as a fire accelerant in the crisis.

And even today, banks in crisis-hit countries in particular are still tempted to over-invest in sovereign bonds, notably of their home country and this tendency has increased further in the crisis. This practice is being encouraged by the preferential treatment afforded to sovereign exposures, which are exempted from the large exposures regime and privileged by low or zero capital requirements.

I believe that regulation should stop encouraging banks to over-invest in sovereign exposures and to tie their fate to their sovereign's solvency. If banks were less exposed to sovereign solvency, this would also add to the credibility of the no-bail out rule under the Maastricht Treaty. In this sense, I appreciate the fact that the Basel Committee has initiated "a review of the existing regulatory treatment of sovereign risk and will consider potential policy options". While it is sensible to conduct this review in a "careful, holistic and gradual manner", it must not be allowed to lead to procrastination.

It is obvious that regulatory changes should be implemented with transitional periods, but a fundamental decision in favour of terminating the preferential treatment should be taken soon.

Ladies and gentlemen

The creation of a Capital Markets Union by 2019 is one of the "flagship projects" of the new Commission, and Commissioner Hill is expected to table a green paper next week.

I share the view that the creation of a capital markets union could stimulate growth in the European Union substantially. But more than that, it could also boost the stability of European monetary union. Studies have shown that private risk sharing through integrated capital markets is a much more important shock absorber than public risk sharing.

When the Bank of England's Deputy Governor Jon Cunliffe recently gave a speech at a City of London event, he said: "Although it shares nomenclature with Banking Union, Capital Markets Union is a very different animal". While the banking union requires a great deal of institutional change, the Capital Markets Union does not. The aim of a Capital Markets Union is rather to create a single market for capital across all 28 EU member states by removing barriers to cross-border investment.

Deeper integration of European capital markets could make a key contribution to improving the absorption of macroeconomic shocks and the impact of heterogeneous economic developments, not only in the euro area but in the EU as well.

The more the capital markets exercise this buffer function, the less fiscal policy will be responsible for stabilising the economy, which will ultimately also reduce the pressure on monetary policymakers to support expansionary fiscal policy by easing monetary policy. In this regard, Jon Cunliffe rightly pointed to the particular importance of this "smoothing through risk sharing" for the euro area "given the relative lack of adjustment mechanisms available to individual euro members when they are hit by shocks".

5. Conclusion

Ladies and gentlemen

Before I conclude, I would like to quote Tom Wolfe's novel The Bonfire of the Vanities, which I mentioned at the beginning of my speech:

"(…) there was no more talk about Bond Bores these days (…) Not at all! (…) All of a sudden, in investment houses all over Wall Street, the erstwhile Bond Bores were making so much money they took to congregating after work in a bar (…) to tell war stories … and assure one another this wasn't dumb luck but, rather, a surge of collective talent. (…) Masters of the Universe!".

This paragraph, taken from a work of fiction, refers to the junk bond boom in the 1980s, and yet it serves as a striking reminder of other financial bubbles, like the securitisation boom during the 2000s. However, financial history has taught us that "surges of collective talent" should be taken with a pinch of salt.

The latest financial crisis clearly underscored that financial markets need strict and prudential regulation. Otherwise, they cannot perform their function of serving the real economy, and the stability of the financial system could be put permanently at risk.

A prosperous economy needs a healthy and efficient financial system. Well-designed financial services help economies to grow.

However, John Kenneth Galbraith also warned: "Financial disaster is quickly forgotten". We should take his words seriously. Complaints of overregulation should not be raised because of short-term concerns about one's own profitability. On the other hand, our regulatory efforts should be subject to cost-benefit analyses, and any assessment of their impact should also take into account the interactions between different regulations.

Hubris, however, is not limited to the private financial sector. Central bankers should not overestimate their abilities, either. If you are looking for "Masters of the Universe", you will find them neither in the private financial sector nor at central banks. Perhaps you will come across them in dusty old toy boxes.

Thank you very much for your attention. I now look forward to your questions.