Jens Weidmann: Economic policy and capital markets – how to promote prosperity in Europe

Opening keynote speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Official Monetary and Financial Institutions Forum (OMFIF) Global Investment Seminar, London, 11 June 2015.

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1. Introduction

My speech today will cover a number of topics, starting with the most recent capital market developments before moving on to monetary policy and economic policies that can make Europe more prosperous.

2. Recent capital market developments

The recent volatility in the bond markets reminded me of James Carville, an advisor of Bill Clinton, who once said: "I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter, but now I want to come back as the bond market. You can intimidate everybody."

Bond investors, at least the ones who were wrong-footed, were certainly intimidated by the most recent jump in bond yields.

To understand the underlying decline in bond prices, which was dubbed the "Bund tantrum" because German Bunds were at the epicentre of the mini-crash, one has to bear in mind the preceding rally, which had been triggered to a large extent by the Eurosystem's sovereign bond purchase programme.

Expectations of a large-scale QE programme depressed long-term interest rates even before the purchases actually began. However, somewhat surprisingly, interest rates dropped still further to unprecedented low levels when the purchase programme kicked off in March. It was a development which many attributed to what they saw as the decisive implementation of the programme, but it was also linked to the gradual emergence of the consequences of some programme details.

Yields on German Bunds with maturities of up to eight years had fallen below zero, suggesting that a certain degree of exuberance was in the air. These developments, fuelled by economic news on both sides of the Atlantic, drove up the number of bond investors who doubted the sustainability of such low yields.

The German FAZ daily newspaper commented on the shift in sentiment: "Some people who just a few weeks ago regarded negative yields as a sign of a serious crisis are now seeing rising yields as signalling a serious crisis, too."

In my opinion, the most recent rise in yields can be largely explained as a correction of a market overshooting – a kind of re-normalisation.

Liquidity might have been an issue, too. With bond prices falling and many investors caught off guard, there appears to have been little appetite for taking long positions in bonds.

For what it's worth, the current level of bond market volatility is not exceptionally high. Indeed, it has been unusually low over the past year. So these market movements are a rather welcome development insofar as they help to foster risk awareness.

What this episode illustrates most of all is that central banks currently have a significant impact on capital markets, as they have become the dominant market player. Yet they are not fully in control of long-term interest rates, try as they might in striving to fulfil their monetary policy mandates.

But this episode also shows that the financial system was able to cope with these market movements.

The ultimate goal of QE is to accelerate inflation in the euro area and to bring the inflation rate into line with our definition of price stability. According to this definition, euro-area inflation should be below but close to 2% over the medium term.

You don't need me to tell you that I was, and I still am, one of the sceptics regarding purchases of sovereign bonds in the euro area. Having outlined my arguments on many occasions, for example at a City of London event in February, I will be brief today.

In a nutshell, I had my doubts about the need for a large-volume QE programme and, against this backdrop, I see risks and unintended side-effects that might outweigh the benefits in terms of an accelerated normalisation of inflation.

While the current inflation rate is significantly below our target, this was driven mainly by a positive supply-side shock caused by lower energy prices. As there were no signs of second-round effects, the risk of deflation was very low indeed. So, an acceleration of the inflation rate was already in the cards, with or without QE – with QE, certainly faster.

This benefit had to be traded against the risks: Central banks are set to become the euro-area member states' biggest creditors. When governments become accustomed to the favourable financing conditions, this could dampen their willingness to consolidate their budgets and implement structural reforms. And it could make governments more keen to try to prevent the ECB from terminating its ultra-easy monetary policy.

At the end of the day, this could jeopardise central bank independence, undermining our ability to maintain price stability.

It can be generally said that monetary policymakers are increasingly being called upon to step in and take action. Let me mention just two items from the wish lists:

1. Keep the Greek financial system afloat by providing emergency liquidity and, thus, help prevent the Greek government from defaulting.
2. Protect economies from the negative outcomes of a supposed era of "secular stagnation" by adopting a more activist monetary policy stance.

Central banks, and this is not unique to the Eurosystem, run the risk of being overburdened. Thus, I think that one of the core issues for monetary policy going forward is finding the right definition of the boundaries of monetary policy.

It is clear that monetary policy can stimulate the economy in the short run. What it cannot do, however, is deliver sustainable growth. Metaphorically speaking, if you have a rowing boat and one of the oars is broken, it is better to try to fix that oar than to paddle with the remaining one.

In other words, successful monetary policy hinges on factors that it cannot fully determine by itself. One key factor is a stability-oriented framework. Such a framework ensures sound public finances and sustainable economic growth.

It is a framework that fosters responsible political decisions by anchoring the principle of liability – that is to say, those who take decisions should be accountable for their consequences. And this is particularly relevant in a monetary union.

In this vein, it is important not to further undermine the no-bail-out rule of the European Treaty. Solidarity can only be expected if conditionality is accepted. Otherwise, the root causes of the problems will not be addressed.

I imagine you can guess that I am talking about the ongoing negotiations with Greece.

There is a strong determination to help Greece improve its public administration, remove barriers to growth and put public finances on a sustainable path. And taxpayers from other

euro-area countries have provided substantial funds to support the unavoidable adjustment processes. But time is running out, and the risk of insolvency is increasing by the day.

The contagion effects of such a scenario are certainly better contained than they were in the past, though they should not be underestimated. But the main losers in that scenario would be Greece and the Greek people.

What I would like to stress here is that an erosion of the principles of monetary union also has consequences for the Eurosystem and the monetary union that no one should downplay.

3. Economic developments

Recent growth figures for the global economy have been rather disappointing. Growth dynamics have dampened, not least in major emerging economies. The US economy contracted in the first quarter of this year due to a brief spell of poor weather. And the UK economy has also seen its growth rate shrink.

The lower oil price is proving to be less of a driving force for the global economy than had been anticipated.

The moderate recovery in the euro area is ongoing, however, and the economy has picked up further momentum. The latest Eurosystem staff macroeconomic projections for the euro area see annual real GDP increasing by 1.5% in 2015, 1.9% in 2016 and 2.0% in 2017.

The German economy has recovered more quickly than expected from the cyclical lull in the middle of last year and has returned to a growth path that is underpinned by both domestic and foreign demand.

Domestic economic activity is benefiting from the favourable labour market situation and the substantial increases in income. Although foreign trade is currently being hampered by dampening global dynamics, it is simultaneously being buoyed by the euro's depreciation and the strengthening cyclical recovery in the euro area.

The Bundesbank's economists expect Germany's real GDP to grow by 1.7% this year, 1.8% in 2016 and 1.5% in 2017.

A puzzling feature of the German economy is the divergence of business investment and employment, all the more so given that financing conditions are extraordinarily favourable. The weak level of business investment might be explained by the high degree of uncertainty over external developments, but it might also point to an anticipated future shortage of skilled labour. In other words: ageing tones down investment.

4. Making Europe more prosperous

The wait-and-see stance adopted by many German enterprises is motivated not least by the modest economic outlook for the euro area.

Boosting growth in the euro area, then, needs to be the top priority. This would not only help the crisis countries to overcome their very difficult economic situation but also benefit all the other member states.

To get to grips with the crisis, it is crucial for the troubled economies to press ahead with their adjustment process. That includes shoring up public finances (in line with the fiscal rules of the Stability and Growth Pact); deleveraging the private sector; implementing structural reforms and boosting price competitiveness.

This, by the way, also holds true for France. While the second-largest euro-area economy is obviously not a crisis country, it has nevertheless seen its competitiveness contract, and its public finances are in bad shape. Moreover, France needs to act as a role model for smaller economies.

The German economy is much better positioned in this respect – the public budget is running a surplus, private debt is acceptable, labour market and social reforms in the last decade have contributed to lower unemployment and to reducing the burden on the social security systems; plus German enterprises are competitive in global markets.

So everything is hunky-dory? Not at all.

Germany's economy may be in good shape right now, but we are not in a position to be complacent. Germany is facing stiff economic challenges, particularly from demographic change, which is also dragging on productivity growth.

According to the EU Commission's latest Ageing Report, Germany's working-age population (people between 15 and 64) will shrink by 28% by the year 2060 compared with a drop of 8% in the rest of the European Union. In France, meanwhile, the working-age population is expected to rise by 5%, in the UK by 11%.

No wonder, then, that only two EU countries (crisis-ridden Greece and Portugal) are expected to see lower potential GDP growth between 2013 and 2060. And even in terms of per capita growth, Germany is mired in mediocrity by European standards, according to OECD projections.

Yet I do not want to focus on Germany. I just wanted to make it plain that mobilising additional growth forces is a task facing the whole of Europe. After all, the title of my speech is "How to promote prosperity in Europe".

Some of you may remember the European Council's Lisbon Agenda. It was set out in the year 2000 and aimed "to make Europe, by 2010, the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion".

Well, obviously, the European leaders were inspired by the Italian artist Michelangelo, who is quoted as saying: "The greatest danger for most of us is not that our aim is too high and we miss it, but that it is too low and we reach it."

Given the apparent failure of this strategy and in the face of an unprecedented crisis, the goals set out in its successor, "Europe 2020", are somewhat less ambitious: the priorities of "Europe 2020" are "smart, sustainable and inclusive growth".

However, stronger growth does not come by declaration. Rather, growth-friendly measures are required – and that particularly means measures that bolster functioning markets. Incidentally, growth-friendly measures would also help to mitigate the risk of the UK leaving the European Union.

The benefits of European integration cannot be measured by net contributions to Brussels' budget. The economic value goes far beyond that because Europe is not a zero-sum game but to the benefit of all – provided that it promotes competitive market structures which unleash innovative forces.

If Europe were really heading for "smart, sustainable and inclusive growth", it would gain attractiveness – not only but also for the UK.

But as much as the UK gains from being part of the EU, so, too does the EU benefit from having the UK as a member. The EU is stronger today because of the UK's contribution to it: The dynamics of the European economy owe a great deal to Britain's commitment to open and flexible markets – a position which is very much in tune with the Bundesbank's, I might add.

In the remainder of my speech, I would like to share my thoughts on ways in which the European economy could become even more dynamic.

4.1 Capital markets union

Financial market fragmentation is certainly a hindrance to growth. Building a capital markets union (CMU), which is one of the European Commission's top priorities, is therefore a step forward towards a more prosperous Europe.

A properly designed and implemented CMU can also deliver greater economic and financial stability. From the Bundesbank's viewpoint, CMU should in particular aim at fostering European equity markets.

Corporate finance in Europe is still heavily reliant on debt, first and foremost bank loans. Taking GDP as a yardstick, the EU banking system is four times larger than its US counterpart. Conversely, equity capital plays a minor role. While the ratio of stock market capitalisation to bank credit to the private sector is well below one in all EU countries, in the US, the respective figure is about two.

However, US enterprises not only benefit from having better access to equity capital. Equity holdings in the US are also much more widely dispersed than in Europe.

Research has found that private risk sharing through integrated capital markets is a much more important shock absorber than public risk sharing. The integrated markets for equity capital in the US cushion around 40% of total cyclical fluctuations between federal states. If a negative shock hits an industry or a specific region, then this loss is spread widely beyond that region.

Creditors, on the other hand, are not exposed to losses – except in the case of insolvency. In other words: equity is a shock absorber, debt is a shock amplifier.

That's yet another reason why we need to promote the integration of equity markets in Europe, too. This should also include venture capital.

When it comes to providing capital to innovative firms, the EU has a lot of room for improvement. In the US, for instance, finding investors is not much of a problem for innovative companies. On average, an innovative US firm can attract significantly more capital than one in the major European countries.

Dismantling national barriers and creating a European venture capital market would help fast-growing, fledgling enterprises to get better access to capital.

While regulation has been harmonised to some extent, however, many crucial domains for venture capital funds, such as investor protection and insolvency law, remain fragmented. Hence, to exploit all economic advantages of a capital market union would imply more legal changes than currently proposed by the EU Commission.

4.2 Barriers to market entry

Another obstacle that particularly stifles growth by business start-ups is red tape. Frequent administrative formalities, long approval periods or high fees make starting a business more complicated and expensive than it should be.

Even though an enterprise's direct costs may appear to be manageable at first glance, the economic cost of difficulties in entering the market and, as a result, weaker competition should not be underestimated.

For example, studies indicate that the differences between the cost of entering the market in the USA and in the EU, though relatively small, could still account for 10% to 20% of the EU's productivity shortfall.

The costs of removing red tape are comparatively low and could help strengthen growth.

This holds true for many European countries – not least for Germany, which ranks 106th in the Global Competitiveness Report of the World Economic Forum on the question "How

many procedures are required to start a business?" – alongside countries like Ethiopia, Zimbabwe, Mozambique and Chad.

4.3 Market integration

Even in the UK, I think, few would doubt that the single market has been a great success benefiting the entire EU. It has simplified trade in goods, intensifying competition and narrowing margins. Nevertheless, market integration remains incomplete.

In the area of services, cross-border competition is under-developed. Mark-ups on the cost of services are, on average, higher than in the USA.

One could say that the European Commission's Services Directive has failed to live up to expectations. In a nutshell, the single market for services is not yet delivering its full potential. Thus, completing the single market for services and ensuring the unhindered cross-border provision of services promise significant economic benefits.

As far as advancing digitalisation is concerned, we do not know exactly how the economic transformation towards greater digitalisation impacts on growth and taxation. But what we do know is that there are currently 28 separate digital markets in the EU.

However, it is clear that the benefits of digitalisation can only be reaped if economies are flexible enough to adjust to changing business conditions.

In Europe, the markets for digital applications are highly fragmented, especially with respect to legal issues such as the protection of privacy, content and copyright. The liability of online intermediaries, electronic payments and electronic contracts are also regulated differently.

Harmonisation in terms of a digital single market (DSM) would certainly contribute to higher potential growth. According to a study by the European Parliament, a completed DSM could raise the long-run level of EU-28 GDP by 4%. And the European Commission, which recently presented its DSM strategy, expects the creation of 3.8 million jobs.

Harmonising rules and regulations is relevant not just for trade in goods and services within the EU. Doing business with trading partners outside the EU is hampered to an even greater extent by red tape, the ongoing existence of tariffs and, above all, other trade barriers.

In many cases, manufacturers have to produce two different versions of the same product to meet the respective requirements of the EU and US markets. This produces unnecessary costs with little benefit. A transatlantic free trade agreement between the world's two largest economies would therefore further stimulate sustainable growth and job creation.

4.4 Flexible labour markets

The most promising way to reap the benefits of innovation and technological change, however, is by implementing structural reforms aimed at creating greater labour market flexibility.

Researchers have found that, compared to the US, innovative European firms find it more difficult to hire the staff they need. This drags on allocative efficiency and, ultimately, on productivity, too.

If we want to mimic US productivity and drive unemployment down to acceptable levels, we need to modernise our labour markets. Overly strict employment protection exerts a "lock-in" effect: workers do not move easily from one firm to the next.

That does not mean establishing a "hire and fire" system. Lower employment protection should be coupled with adequate financial support in the event of a job loss.

Scandinavian countries have led the way with their "flexicurity" reforms and, fortunately, an increasing number of euro-area countries are following suit.

4.5 Good infrastructure

Just like flexible labour markets support growth, so too does good infrastructure. Conversely, infrastructure weaknesses can inhibit growth considerably.

In this regard, it is often claimed that Germany should increase its infrastructure investment. Even in Germany, it is en vogue to complain about ailing infrastructure. The weekly magazine Der Spiegel, for example, last year published an issue entitled Der Bröckelstaat – "the crumbling state".

However, there are neither comparable international data nor any theoretical considerations suggesting that Germany is investing too little. In 2014, the ratio of gross fixed capital formation to GDP in Germany was slightly up on the euro-area average and also higher than in the UK.

Moreover, investment does not boost growth prospects per se. In fact, that would be putting the cart before the horse. Better prospects for growth, and therefore for profit, are the best incentive to invest.

International surveys show that Germany is considered to have one of the best infrastructures in the world. The Global Competitiveness Report I mentioned earlier in my speech ranks Germany's infrastructure in seventh place, just ahead of France, Spain, the UK and the US. And the World Bank's Logistics Performance Index even puts Germany's infrastructure in first place worldwide.

Having said that, I would not deny that there is some room for improvement in public investment, given that net investment has been negative for some time now.

International comparisons suggest that German public investment is too low. This, however, should be taken with a pinch of salt. The ratio of public investment to GDP hinges on the role of the state in the economy, which differs widely across Europe.

Provided that public funds are primarily invested in areas in which they will pay off, this improves the economic supply conditions and, in the long term, growth potential. However, it would be unnecessary and wrong to fund higher public infrastructure investment through new borrowing. Rather, it should be made possible by cutting consumptive expenditures.

Calls for a deficit-financed economic stimulus in Germany are misplaced. In this regard, what former ECB chief economist Otmar Issing wrote in a Financial Times article last October still holds true to this day:

"Imagine you are asked to give advice to a country on its economic policy. The country enjoys near-full employment; its growth is above or at least at full potential. There is no under-usage of resources – what economists call an output gap – and the government's budget is balanced, but the debt level is far above target. To top it all, monetary policy is extremely loose. This is exactly the situation in Germany. (…) Where is the economic textbook that argues that such a country should run a deficit to stimulate the economy?"

5. Conclusion

Let me conclude.

My objective was to make it plain that monetary policy is the wrong addressee when it comes to promoting prosperity in Europe.

It is still true that maintaining price stability is the best contribution that monetary policy can make to achieving sustained economic growth in the long run.

Since I quoted James Carville earlier on, I would like to close by modifying his most famous phrase "It's the economy, stupid." into: It's not monetary policy that provides prosperity. It's forward-looking economic policy that sets the course for sustainable growth.

Thank you for your attention.