Jens Weidmann: A central banker's take on improving the euro area's stability

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the Bank of Portugal, Lisbon, 10 December 2015.

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1. Introduction

Governor Costa, Ambassador Brandenburg, President Martinho

Distinguished members of the Portuguese Government and the Portuguese Parliament

Ladies and gentlemen

Thank you very much for inviting me. It is a pleasure to be here in Lisbon. I am very honoured that the event this evening has attracted such a distinguished audience.

In my speech today, I will address the future of EMU – the economic and monetary union in Europe. I will focus on the issue of making the euro area more prosperous and making the common currency more stable.

The euro has always been a political project with the aim of establishing ever closer ties between the nations of Europe. But, of course, it is more than just a political project – it also holds out the promise of prosperity.

In recent years, this promise has lost credibility for many in the euro area, prompting some to regard the requirements of our common currency not as an anchor of stability, but as a source of instability. Interestingly, this view is shared by both: observers complaining about the institutional framework being too restrictive to allow for national stabilisation policies, and those complaining about monetary union evolving into a transfer union, which is contrary to the stipulation of the Maastricht Treaty.

It is undisputed, however, that the rescue mechanisms that were put in place prevented the crisis in the euro area from escalating. But they did so by mutualising fiscal liability on a substantial scale.

Fiscal and economic policies, by contrast, are essentially still a national prerogative, though the rules have admittedly been stiffened somewhat. As a result, the balance between liability and control has been thrown out of kilter.

However, such a balanced partnership between liability and control is so crucial for the functioning of EMU that it calls to mind a Frank Sinatra song called "Love and marriage". You may remember the words:

> Love and marriage, love and marriage / they go together like a horse and carriage /
> This I tell you brother / You can't have one without the other / ...
> Try, try, try to separate them / It's an illusion

However, while some would argue that love and marriage are separable concepts, it really is an illusion to separate liability and control without undermining the stability of monetary union. And there is no getting around the fact: a combination of national sovereignty and common solidarity can pose a risk to the stability of our monetary union.

A large measure of solidarity certainly helps a country in crisis to cope in the short run. But, allowing a national fiscal burden to be shifted onto the community of all member states will weaken incentives for sound fiscal policy in the long run.

The underlying economic problem here is known as the "tragedy of the commons". This is a situation in which every individual tries to reap the greatest benefit from a given resource. Let's take the example of overfishing: Just as fishing by the crew of one fishing boat reduces the number of fish available for others and threatens the entire fish population in the long run, excessive public debt harms the euro area as a whole. Rising debt in one member state drives up longer-term interest rates for all euro-area countries. And if the excessive debt of one country poses a threat to the financial stability of the entire euro area, the viability of the whole project might be called into question.

The point of the tragedy of the commons is that it is, from a certain narrow point of view, entirely rational for a single fishing vessel to catch as many fish as it can, thus destroying the basis of such economic activity for others and for future generations. So, what we have here is a classic coordination failure.

2. EMU's architecture

Ladies and gentlemen,

In their report on completing EMU, the Five European Presidents compare the monetary union with "a house that was built over decades but only partially finished. When the storm hit, its walls and roof had to be stabilised quickly".

However, after all those quick fixes in recent years, it needs to be decided how the house should look in the future, and if I may quote the Five Presidents again: "It is now high time to reinforce its foundations".

The latter is certainly true, but you can come to very different conclusions about how to construct those foundations.

To find out how the euro area could develop, we first need to take a closer look at the special terrain occupied by Europe's monetary union. What sets our monetary union apart from other currency areas?

I think the difference can be summed up in a single word: asymmetry. EMU unified monetary policy. But, fiscal and economic policies continue to be a national matter, albeit subject to coordination rules.

As I have already mentioned, this asymmetry can give rise to instability. If the consequences of an unsustainable national economic policy can be shifted onto others – for example, through bail-outs or via the conduit of a common central bank balance sheet – incentives for prudent policymaking will be stunted.

Still, hopes were high that, with sufficient safeguards in place, an asymmetrically integrated euro area could prove to be stable as well. As we now know, that hope has not been fulfilled. The safeguards installed to ensure sound public finances, such as the Stability and Growth Pact and the no bail-out clause, have failed to keep public debt in check.

Beyond that, the framework also had its shortcomings. It did not provide for resolution mechanisms to deal with the financial fallout of private over-borrowing. Nor has it prevented economic imbalances from building up, which eventually required painful adjustment policies in some euro-area countries.

2.1 Rebalancing at national level

Ladies and gentlemen,

In his novel Anna Karenina, Leo Tolstoy famously observed that happy families are all alike, while every unhappy family is unhappy in its own way. This insight puts me somewhat in mind of economic developments in the euro-area countries over the first decade of EMU.

The underlying reasons why euro area economies got into trouble differed from country to country. Nevertheless, there are some factors which are more or less common to all "unhappy" countries.

In some cases, lower interest rates brought about by monetary union and inflowing capital fuelled unsustainable developments. The resulting domestic boom and existing labour market rigidities led to large wage increases well in excess of productivity growth, triggering a loss in price competitiveness, thereby impairing export performance. Current account deficits were therefore ultimately a symptom of countries living beyond their means.

Portugal, for example, had a current account deficit before the crisis amounting to 12 % of GDP, which was definitely not sustainable.

Economic adjustment was therefore unavoidable. And if countries like Greece, Ireland and Portugal had not drawn on European and international solidarity, the adjustment process would have been much more abrupt. The sudden stop of external capital inflows would have forced those economies to balance their current accounts immediately.

In response to the crisis, Portugal implemented considerable consolidation measures and structural reforms. And the ongoing recovery not only of the Portuguese economy but also of the Spanish and Irish economies proves that the adjustment efforts are paying off.

In order to reap more benefits and to create a higher growth potential, fiscal adjustment, structural reforms and moderate wage policies need to be continued. Otherwise, the country in question would not be able to stop the increasing backlog regarding GDP per capita compared to the European Union or even reduce it.

I am aware that such policies are not always popular, but as the Portuguese professor of finance, Pedro Santa-Clara was recently quoted as saying in the Financial Times, “Growth is a painful business”. And I would add: “But having no growth is even more painful.”

Growth-enhancing reforms in individual countries including Germany are only one element, of course. Measures at the European level could likewise boost innovation, productivity and employment. In particular, I believe that the completion of the single market for services, the creation of a single digital market and the capital market union could constitute an important growth impetus.

One of the most important lessons to be learned from the recent crisis is, however, that member states must adapt better to the requirements of a monetary union. This means, in particular, to adapt to the fact that wage increases above productivity growth can no longer be compensated by currency devaluations.

But the crisis has also made it obvious that national economic policies need collective surveillance. To quote Governor Costa: “It is clear for all of us today that the stability and prosperity of the euro area as a whole depend on the stability and prosperity of its individual members.”

In other words: regarding national imbalances, benign neglect must belong to the past. This is, by the way, also true of economies with persistent current account surpluses. A surplus of more than 8% of GDP, such as we are currently seeing in Germany, is an economic challenge, too.

On the other hand, it needs to be recognised that this high figure is not the result of protectionist economic policy measures, and that the recent rise is caused, not least, by the devaluation of the euro – also linked to the divergent monetary policy on both sides of the Atlantic – and by the fall in energy prices. Moreover, it should be noted that a surplus country – in contrast to a deficit country – is not at risk of being corrected abruptly, and is therefore less vulnerable.

However, reinforcing the foundations of monetary union requires more than the prevention of new imbalances at national level. It requires institutional reforms at European level.

2.2 A fiscal union

In their approach, the Five Presidents are aiming – metaphorically speaking – at a more symmetric approach. Completing EMU, as they understand it, implies risk-sharing and centralisation of economic policy issues.

Even for Karl Otto Pöhl, the former Bundesbank president who was a member of the Delors Commission, the symmetric approach was the intuitive one: "In a monetary union with irreversibly fixed exchange rates, the weak would become ever weaker and the strong ever stronger. We would thus experience great tensions in the real economy of Europe. For this reason alone, monetary union without the simultaneous integration in fields like fiscal policy as well as regional and social policy is completely inconceivable."

Creating a fiscal union – that is, centralised decision-making in the fiscal realm, combined with fiscal transfers or mutual liability in the form of Eurobonds could make EMU less vulnerable. The balance between control and liability would be restored.

Shifting decision-making from the national to the European level would mitigate the deficit bias of the individual member states that is inherent in the current set-up of EMU. While this in itself is not a guarantee of sound fiscal policy choices, such a framework would at least be consistent with the concept of mutual liability.

What kind of sovereignty shift are we talking about? Last year, the French finance minister Michel Sapin declared that, "the Commission […] has absolutely no power to reject or knock down or censure a budget […]. Here as elsewhere, sovereignty belongs to the French parliament."

In a genuine fiscal union, that would change. A member state would have to follow through on the demands of a European fiscal authority. As such, a common fiscal authority would be the biggest step in integration since the introduction of the euro. It would be a tall order that would entail treaty changes and referendums. But anything less than a comprehensive shift of sovereignty would fall short of what is required. This holds true regardless of whether we move to a common euro-area treasury with its own budget or to a system allowing interventions in existing national budgets.

Europe shying away from the political ramifications of a fully-fledged fiscal union would leave only one viable option – a decentralised approach based on individual responsibility, which means continuing on the path taken by the founding fathers of the Maastricht Treaty.

In this asymmetric approach, economic and fiscal policy decisions remain largely at the national level. But final responsibility rests with the individual member states as well.

Asymmetry does not automatically have to translate into instability. Just take a chair: a chair with three legs never wobbles; one with four legs sometimes does. A chair with three legs, remember, is always stable because three is the minimum number of points to define a plane. When all points lie on the same plane, the chair will be stable. If you add another leg, its end must also lie on that plane, otherwise things get wobbly. So, it is not about whether the legs are arranged symmetrically; it is about whether their feet are on the same plane.

The same applies to monetary union. It is not necessary for all policy areas to be integrated symmetrically. What is necessary is that control and liability be situated on the same plane. Only by aligning control and liability either nationally or at the European level will the incentives for sound policymaking be put in place. This is why the measures taken so far to contain the crisis have skewed the delicate balance between control and liability.

The crucial question is this: how can we restore that balance within the decentralised approach?

2.3 A framework of individual responsibility

A workable decentralised approach would, in particular, have to deal with a blatant inconsistency in the current framework which makes the system as it stands fragile. While bail-outs and monetary financing are prohibited under the Maastricht treaty, sovereign debt is nonetheless treated as risk-free in the capital regime for banks.

Danièle Nouy, the chairwoman of the European banking supervision, said: “Sovereigns are not risk-free assets. That has been demonstrated, so now we have to react.”

I totally agree with her. Sovereign debt in banks’ balance sheets needs to be backed by capital, just as is the case for any private debtor. But perhaps it is even more important to put a lid on banks’ exposures to a single sovereign.

Sovereign risk is a cluster risk – that is, a risk so large that the default of a single debtor can bring a bank to its knees. To prevent this from happening, banks are subject to the large exposure regime, which means that they can only lend up to 25 per cent of their equity to a single debtor. This means that banks will be more likely to have enough capital to cope with a single debtor’s default.

Sovereigns, however, are currently exempt from the large exposure regime. As a result, banks often hold an amount of bonds of their home country alone that exceeds the total of their equity. Particularly during the sovereign debt crisis, banks increased their holdings of domestic debt securities.

According to an Economic Study by Banco de Portugal[1], holdings of Portuguese government bonds on the balance sheets of domestic banks in Portugal are approximately five times higher than before the crisis. Other countries, and in particular those with vulnerable banking systems have experienced strong increases in sovereign debt exposures and home bias, too.

That is why a sovereign debt restructuring currently poses the threat of bringing down the national banking system in question. And this is why, for a decentralised framework to function, the large exposure regime has to apply to bank lending to sovereigns as well. Simply doing away with the zero-risk weighting will not suffice. Banks’ exposures to their respective sovereigns are often too large.

Capping the amount of debt issued by a single sovereign that a bank can hold does not necessarily mean that a bank will hold less sovereign debt overall. It can still buy the debt of other sovereigns, up to the individual limit.

What it does mean, therefore, is that banks cannot put all their sovereign eggs into one basket, so to speak. Diversification is of the essence. And this will go a long way towards ensuring that a sovereign debt restructuring will not bring down a country’s national banking system – leading to a vicious cycle with wobbling banks and stumbling states clinging to each other.

Besides, there is no compelling economic argument why banks should be the main financiers of sovereigns in the first place. Banks’ long-standing ties with their private clients allow them to glean information about firms and managers. This information allows banks to allocate capital more efficiently than other intermediaries who lack such information. In the process, banks create value for the economy as a whole.

However, banks do not have such privileged information on the debt of a nation – especially on the debt of central governments. It makes sense for banks to hold a certain amount of sovereign debt for liquidity purposes. But there is no reason why the financing of governments should not be more of a matter for the capital markets.

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1 Crosignani, M et al., The Portuguese Banking System during the Sovereign Debt Crisis, July 2015.

Doing away with the regulatory privileges afforded to sovereign debt would force the markets to take account of the differences in sovereigns' risk profiles. For countries that pursue sound policies, this would mean declining risk premiums, while unsustainable policies would be sanctioned. And, as a last resort, a sovereign debt restructuring would be possible without bringing down the financial system.

However, changes are in order not only with regard to the capital regulation of sovereign bonds. In a framework of individual responsibility, we need to make sure that responsibility rests with those who assumed the risks in the first place.

As it is, a member state that loses market access can apply for an ESM rescue programme that combines financial assistance with economic reforms. If things work out as planned, deficits are brought down, growth capacity is raised, and market access is restored.

However, if things do not work out as planned and the member state in question does not regain market access, the only way out might be a restructuring of the debt burden. But by then, the European taxpayer has already picked up part of the bill, as private bond holders have been replaced by the ESM.

One way to change this would be an automatic three-year maturity extension for all bonds, activated the moment a government applies for an ESM programme. Such an automatic maturity extension would allow the sovereign in question to tackle its fiscal challenges while preventing investors from bolting. The amount of official financial support via the ESM would be greatly reduced, and time could be bought to figure out if the problem really is one of temporary illiquidity or one of insolvency.

A framework of individual responsibility requires not only that creditors are fit to absorb the losses from a sovereign debt restructuring, but also that they actually do so when the going gets tough. Obviously, it would be best if the need for sovereign debt restructuring never arose in the first place.

2.4 A fiscal council

This is where fiscal rules come in.

Prior to the crisis, the binding force of the euro-area fiscal rules was modest, to put it mildly. Thus, when the crisis hit, many countries had little fiscal space to counter its impact. This highlights the importance of fiscal buffers. And following up on a lesson of the crisis, the rules were stiffened somewhat.

But, at the same time, the Commission was granted more leeway in interpreting the rules. So far, the Commission has made ample use of this additional leeway, thereby thwarting the original intention of the revised rules.

In my opinion, it would be best if the task of applying the rules were to be transferred to a new, independent fiscal council. This could help to unburden the Commission of its difficult political conflict of interest. On the one hand, the Commission is an important political player searching for a balance between the member states' different interests. On the other hand, it has to be a neutral referee in assessing compliance with the Stability and Growth Pact.

The Five Presidents' report also envisages such a council, and recently, the Commission has followed up on the report and come forward with a proposal. But, as the ECB rightly points out in its current Economic Bulletin, the Commission's proposal suffers from a number of shortcomings.

The proposal does not make provision for the evaluations of the fiscal council being made public in a timely manner. If the alarm is raised too late, it might be a case of trying to shut the stable door after the horse has bolted.

What is more, the Commission has dropped the comply-or-explain approach outlined in the Five Presidents' report, under which the Commission would have to explain itself whenever it deviated from the recommendations set out by the fiscal council.

This does not bode well for the objective of a more depoliticised application of the rules. For that, a fiscal council needs to be truly independent, and its recommendations need to carry weight.

And please let me emphasise again: fiscal rules are neither needless nor damaging for the euro area. This holds, even in these times of the extraordinary high influx of refugees or the struggle against terrorism. The fiscal rules already allow for additional public expenditures if they are irrefutable and unforeseeable as well as closely related to these extraordinary circumstances.

But more generally, the current debate about softening the Stability and Growth Pact is misleading, because it conveys the impression that sound fiscal budgets would get in the way of fulfilling important public duties. The opposite is true, however. Sound public finances are a precondition for being able to handle specific challenges. Correspondingly, Germany currently benefits from its budgetary surplus because it grants fiscal leeway for the expenditures related to refugees.

3. Conclusion

Ladies and gentlemen, let me conclude.

Today, Economic and Monetary Union does not look like other successful currency areas. Maybe it will never match their degree of symmetry with regard to policy integration. But perhaps some findings about our perception of beauty can provide a little encouragement. While symmetry appears to play a role in whether we consider a face to be attractive, researchers have found that this is only part of the story. Apparently, it is the little deviations from the norm, the minor asymmetries, that render a face truly beautiful.

But we still have a long way to go before Europe's citizens perceive EMU as truly "beautiful".

I am now looking forward to discussing with you the future of our monetary union.

Thank you for your attention.