Jens Weidmann: The euro area in 2016 – crucial to set right course for enhancing growth and 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 International Club La Redoute e.V., Bonn, 28 January 2016.

* * *

1. Introductory remarks

Gräfin Lambsdorff,

Ladies and gentlemen,

Thank you for your kind welcome and for inviting me to your club. I was pleased to accept your invitation. I am probably partial to requests to speak in Bonn – and I mean that positively – due to my old ties to the University of Bonn. After all, I studied here for a number of years and obtained a degree in economics and a PhD here, thus acquiring a large chunk of my economic "toolkit" in this city. However, a more important reason for accepting your invitation was the fact that you regularly address current European policy topics. I am sure that we will therefore have a lively debate at the end of my speech.

Ladies and gentleman, as you know, 2016 is a leap year. There have been leap years since the time of Julius Caesar. They take account of the earth taking a little more than 365 days to orbit the sun. According to calculations by the Greek astronomer Hipparchus – which would have been known in Caesar's time – it took 5 hours, 55 minutes and 12 seconds longer, though he was a few minutes off according to modern-day calculations. There ended up being one leap year too many every 128 years; as a result, by the mid-16th century spring had been brought forward 10 days. This needed to be corrected, and Pope Gregory XIII did this with his Gregorian calendar, which is still used today.

The introduction of the Gregorian calendar set the course for a calendar that keeps track with the seasons. When we talk today about setting the right course for a more stable and growth-promoting regulatory framework for monetary union, we get the impression that this requires a more complex process than the introduction of the Gregorian calendar. But we merely need to take a leaf out of Pope Gregory XIII's book of long-term thinking. We don't need to look forward centuries in one fell swoop. It would already be a big step forward if we were to address the challenges looming in the coming years and decades.

However, we have already been discussing the right course to set in Europe for seven years now. Children born at the outbreak of the crisis have now already learnt to read and write, while in the euro area we are still going through the A to Z of the terms and conditions that will bring the euro area more stability as well as more growth.

Against the backdrop of the rise to power of populist parties in many crisis countries, Italian Prime Minister Matteo Renzi, for instance, said in an interview with the Financial Times just before Christmas: "We can defeat this demagogy, apathy and populism by betting on the growth and employment of a new social Europe." And he added: "We have to be careful with our finances, but it has to be less about commas and decimal points."

Ladies and gentleman, are growth and fiscal solidarity really at odds with each other, as is implicitly assumed by Renzi with his reference to commas and decimal points? I do not think so. A looser fiscal policy can temporarily jump-start economic growth. However, in the longer run, lasting growth cannot flourish on an ever growing mountain of debt – this is precisely what the sovereign debt crisis in Europe has made clear. Furthermore, numerous empirical studies demonstrate that once debt goes beyond a certain level it impedes growth.

And is Renzi right in alleging that the discussions in Europe are really just focused on commas and decimal points? I get the impression that the fundamental issue here is rather obeying rules. But rules don't mean anything unless they are obeyed. In my opinion, confidence in the binding power of the joint agreements is essential for the functioning and acceptance of monetary union. And this is all the more the case when Europe's problem-solving skills are being put to the test and there is an evident tendency among some member states to go it alone.

Moreover, monetary policy also benefits when fiscal policy rules are obeyed. The crisis has namely also shown how much pressure monetary policy can come under if confidence in the soundness of public finances is lost and risks for financial stability emerge. However, stable money is a key pillar of our economic system and a prerequisite for lasting growth. Before I turn my attention to how to enhance growth in the euro area and make the regulatory framework of monetary union more stable, I would first like to say a few words about the current monetary policy.

2. Monetary policy

Ladies and gentleman, there is no doubt that the current monetary policy situation is not an easy one, with downside risks to inflation in the euro area having increased recently. This concern is also evident in the introductory statement of the ECB Governing Council last week. There is no doubt that uncertainty is currently running high. Given the recent financial market turbulence in China, the continued drop in oil and commodity prices and the heightened geopolitical risks, doubts are being raised in some quarters as to whether the international environment is still providing the stimuli for euro-area growth that were incorporated into the December Eurosystem staff projection, with economic growth for 2016 and 2017 expected to be 1.7% and 1.9%, respectively.

However, we shouldn't paint the economic outlook blacker than it actually is. The financial market turbulence in China at the start of January and its partial transfer to the rest of the world demonstrate the nervousness of the financial markets. However, the price falls in China can primarily be viewed as further corrections to earlier, sharp price rises. And they were undoubtedly also reinforced by an ill-timed regulatory measure. In my opinion, there are currently no signs of a severe economic slump in China. Instead, there are indications of a gradual slowdown in economic growth. This is consistent with China's transition to a more service-oriented, domestic-driven economic model.

Furthermore, the unusually sharp oil price drop is now weighing heavily on numerous oil-producing countries. Many of these countries are on the brink of, or have already tipped over into, a recession, which is why they need to tighten the reins on public and private sector expenditure. As net importers of crude oil, Germany and the euro area are receiving a boost to their economies, as petrol and heating costs are falling further and many firms are able to manufacture and produce goods more cheaply. The fall in energy prices compared with the level included in the December Eurosystem staff projection will probably yield estimated savings of just over half a percentage point for consumers and enterprises this year – both in Germany and in the euro area as a whole.

The flip side of the oil price drop in monetary policy terms is, however, that downside risks to the inflation outlook have also increased. The inflation rate will not rise again until later than previously anticipated and there will probably need to be a substantial downward revision of the inflation forecast for this year. The fact that the Eurosystem will not achieve its price stability goal over an extended period of time will undoubtedly put the credibility of monetary policy to the test. We must therefore pay particularly close attention to longer-term inflation expectations. This is because they are an indicator of confidence that the self-imposed monetary policy goal of an inflation rate below, but close to, 2% over the medium term will be achieved.

Moreover, we must also carefully monitor possible signs of second-round effects. Some believe that the current wage growth rates in the euro area are already sounding warning bells. I don't agree, however. As some crisis countries will still need to increase their price competitiveness in order to regain lost global market shares, wages there can only rise moderately. This employment-oriented wage policy is thus putting pressure on wage growth. Yet, on the other hand, the improving labour market situation is boosting consumption.

When assessing price risks, we shouldn't be like a rabbit caught in the headlights, fixated on the current consumer price inflation rate. This rate could, in fact, temporarily slip back into negative territory during the spring quarter. Monetary policy should look beyond these short-term oil-price-induced fluctuations in consumer prices. Domestic price pressures are better reflected by the core inflation rate, which factors out such effects. Although, at 1%, this rate is currently also below the price stability target, it is rising and is far removed from the dangerous territory of deflation, that is to say the territory in which we would have to fear a downward spiral of sinking prices, falling wages and an economic downswing.

3. Paths leading to stronger growth

Ladies and gentlemen, the purpose of the Eurosystem's highly accommodative monetary policy is to stimulate economic activity in order to bringing inflation into alignment with the definition of price stability. Private consumption in the euro area has been picking up perceptibly, and not just because financing conditions are favourable – low oil prices and inflation are another factor. Investment, meanwhile, is only now gradually getting off the ground.

Investment, of course, is more than just a component of aggregate demand in the economic process – it also has a bearing on the size and quality of the economy's capital stock. Investment in machinery and equipment, especially, keeps production structures up to speed with technological advances, making it a useful lever for lifting an economy's output and ultimately its growth as well. Investment in machinery and equipment may have been back on the increase since early 2013, but across much of the euro area it has still not yet returned to pre-crisis levels. One glimmer of hope, of course, is that the impediments to investment will gradually peter out over time. The adjustment and reform processes in the crisis countries are making headway, and financing conditions are looser again than they were when the crisis was raging. This means that two major burdens on investment have been removed.

However, one major impediment lingers on – the outlook for growth – a hugely important factor for investment – has been revised downwards in recent years. The European Commission projects that, in the absence of further growth-enhancing reforms, the medium-term growth outlook will be no better than 1% per annum. It is this malaise, and not deficit-financed stimulus programmes, that needs to be addressed by economic policy. The same can be said for Germany, where negative demographics look set to play a major role in depressing potential output growth.

Incidentally, Gräfin Lambsdorff, the idea of making each country individually responsible for creating growth-friendly conditions was something which your late husband already expounded in his famous "Lambsdorff paper". That document back in 1982 spelled out his plan for boosting growth in Germany and probably sounded the death knell for the SPD/FDP coalition. Pointing to the stubborn adjustment crisis that was stifling the global economy at that time, Graf Lambsdorff wrote: "It will only be possible to find a solution – at least a lasting one – to the worldwide problems if the individual countries themselves do away with what's making it difficult for them to adjust."

The efforts needed to clear the debris after the financial and sovereign debt crisis sometimes addressed shortcomings of a very fundamental nature. Greece, for instance, urgently needs a reliable and functioning administration and a more efficient public sector, not to mention measures to sustainably consolidate its public finances and further reform steps to make Greece a more competitive economy. And Italy, too, could place its economy on a much more

rewarding growth path by streamlining its public administration and making its legal system more efficient. It is gratifying to note that the constitutional reforms on which prime minister Matteo Renzi has staked his political future are moving in the right direction. This initiative will enable parliament to adopt legislation more quickly. Once the reform measures have been formally and fully approved by parliament, the final step in the process will be a public referendum, most likely in the autumn.

In some countries, the efforts to mop up the post-crisis carnage have centred around the question of debt. High levels of household and corporate debt in some euro-area countries are continuing to stifle overall economic activity, particularly investment. But private indebtedness is not the only topic on the agenda – public debt also needs to be addressed. A string of euro-area countries have made huge progress in scaling back their fiscal deficits since the onset of the sovereign debt crisis – indeed, Greece, Ireland and others deserve plaudits for paring back their annual deficits by ten percentage points or more. But more often than not, countries are still crashing through the 3% deficit ceiling. And if we factor cyclical gains and temporary measures out of the deficit numbers, then the structural deficits, as they are known, have been static at best or even going back up. Essentially, the opportunity opened up by the low interest rates to bring down structural deficits particularly quickly was squandered.

In the key area of labour market reforms, countries like Italy, Spain and France have made tangible progress in the right direction since the crisis struck. But employment could be boosted further still if France and Spain, say, act even more decisively to address the divide splitting their labour markets into temporary and permanent employment contracts.

The goods markets are another area where key decisions unleashing the forces of growth can be made. For instance, some European countries have rules which inhibit the growth of small enterprises. But when highly innovative small businesses are prevented from scaling new heights, this stunts economic growth. Another case in point is the red tape involved in setting up a business, which is a major hurdle across much of Europe and, I might add, especially so in Germany. The World Bank's Doing Business Report ranks our country 107th for red tape, alongside Antigua and Barbuda and behind Nepal and Ghana. So we're not "best practitioners" in this respect, not by any stretch of the imagination.

And there are other areas where Germany would be unwise to rest on its laurels. Potential growth is just a meagre 1.3%, and globalisation and the "energy U-turn" are exposing the economy to mounting competitive and cost pressures. More importantly, German society is feeling the effects of radical demographic change, which will take its toll on the country's growth prospects. Over time, the working-age population will diminish and the number of people in work will shrink, causing growth to falter further. The current influx of refugees will do little to alleviate this problem.

We may be powerless to halt the wheels of demographic change, but we can at least soften its blow on the economy. To achieve that goal, we would have to

- focus more strongly on education and training – that is, on labour productivity
- boost the participation of women and the elderly in the labour force still further
- improve the way the long-term unemployed are integrated into the labour market
- integrate into our labour market those refugees who are permitted to stay in Germany.

Our success in integrating refugees into our society will hinge in large measure on how quickly and smoothly these immigrants can be absorbed into the labour market. But that's a task that will take stamina and patience, because language difficulties won't be the only problem for the vast majority of refugees; their qualifications will probably be found wanting, too.

Ladies and gentlemen

The individual member states aren't the only ones who can put their economies on track for stronger growth – the European Commission and Council can contribute as well.

They could, for instance, work towards bringing together the 28 separate digital markets that still exist in Europe to finally create a pan-European digital market that extends from Hammerfest to Heraklion. Studies suggest that, in Germany alone, a single European digital market could create more than 400,000 new jobs within the space of a few years. And the establishment of the capital markets union is another project where the European Commission is at the wheel. Broad, well-developed capital markets will offer fresh sources of funding for businesses, again paving the way towards stronger growth.

4. Architecture of the monetary union and the path to greater fiscal soundness

A full economic and monetary union should also include a capital markets union. As you know, last year, the President of the European Commission Jean-Claude Juncker and the presidents of four other EU institutions published a report entitled “Completing Europe’s Economic and Monetary Union”. In it, the five presidents wrote, “Europe’s Economic and Monetary Union today is like a house that was built over decades but only partially finished. When the storm hit, its walls and roof had to be stabilised quickly. It is now high time to reinforce its foundations [...].”

The time has indeed come to strengthen the foundations of the monetary union, and a sound institutional architecture is undoubtedly also a key prerequisite for a prosperous euro area. I would therefore like to take a closer look at the architecture of the euro area and outline how we might improve its stability.

If we were to try to compare the architecture of the euro area to that of a real building, I don’t think the La Redoute here in Bad Godesberg would immediately spring to anyone’s mind. This beautiful building is simply too symmetrical. Instead, you would probably think of structures such as the Guggenheim Museum in Bilbao or the Gehry buildings in Düsseldorf’s Media Harbour, because one of main features of the euro area is its asymmetry. It brings together 19 largely autonomous fiscal policies under a single monetary policy. Nobody would say that asymmetrical buildings such as those I have just mentioned cannot be structurally stable, but they are bound to require complicated calculations.

To a certain degree, the founding fathers of the monetary union also performed structural calculations and were aware that their asymmetrical design contained flaws. The risk of accumulating excessive debt is greater in a monetary union than in countries with their own currencies. One reason is because the member states of a monetary union are not borrowing in their own currency. Another is that there are greater incentives to borrow in a monetary union because any consequences of relying too heavily on capital market funding can be passed on to the other member states – at least in part.

I usually like to compare this to the overfishing of our oceans. However, here in Bonn, the UN’s “climate capital”, I would prefer to compare it to greenhouse gas emissions. The damage caused by CO2 emissions is global, whereas the benefits from, say, the burning of fossil fuels, are local. This simple logic explains why preventing climate change is so difficult in practice. The dilemma can only be solved through international cooperation. The Kyoto Protocol was intended to protect the atmosphere and reduce greenhouse gas emissions, and it remains to be seen whether this will finally be achieved thanks to the agreement recently signed in Paris.

To protect the single currency and prevent excessive debt, the member states of the euro area have also agreed on a “Kyoto Protocol” of their own – the Maastricht Treaty, which includes the Stability and Growth Pact. Under the terms of the Treaty, the member states pledged to maintain sound public finances and prohibit central banks from printing money to fund cash-strapped governments – also known as the ban on monetary financing of governments. They also agreed to a “no bail-out clause” that prevents one member state from assuming liability for the debts of another. This means that the euro-area member states are individually responsible for the consequences of their own excessive borrowing. It is also intended to encourage the capital markets to factor risk into the interest rates at which they lend to governments.

This regulatory framework based on the principle of liability – the Maastricht framework – was the starting point for the creation of the monetary union in 1999. In its first decade, it proved to be a stable structure. However, with hindsight, this also turned out to be a period of fine weather in economic terms. But then, to quote the five presidents again, the "storm" arrived in the guise of the financial and debt crisis, which is why "the walls and roof had to be stabilised quickly". The crisis revealed that enormous macroeconomic imbalances had built up in some countries over the initial period of calm. Alongside the huge increase in public and private-sector debt, international competitiveness had also been eroded. A number of these imbalances exposed the blind spots in the regulatory framework of the monetary union.

In response to the crisis, a procedure for identifying macroeconomic imbalances at an early stage was therefore established, in which the European Commission regularly examines whether, for example, private sector debt or member states' current account balances are a source of harmful imbalances. When trying to repair the damage, however, a great deal of energy was also devoted to strengthening fiscal soundness. For instance, a fiscal compact was adopted to make the fiscal rules of the Stability Pact more stringent and binding, thus boosting confidence in the sustainability of public finances. It was this very lack of confidence that was at the heart of the sovereign debt crisis. The binding effect of the fiscal rules had already been weakened before the crisis. First, the financial markets appeared not to take the no bail-out clause seriously, and second, Germany and France successfully avoided sanctions over their excessive deficits in 2005, leading other countries to believe that they, too, could bend the rules.

While the crisis was being tackled, elements of communitised liability gained ground. Although the no bail-out clause still applies in theory, its foundations have been eroded to some extent in practice, most notably by the European rescue packages. At the time, this communitisation of liability helped to stabilise the situation.

However, joint liability can only lead to lasting stability in combination with joint control. This is because liability and control must be aligned, either at the national or the European level, or the principle that each member state must "pay its own way" would be breached.

The financial crisis also illustrates just how serious the consequences of circumventing the liability principle can be. For year, banks had taken excessive risks because, for example, they were too big and too interconnected to fail, and could expect taxpayer-funded bailouts. This is why many of the regulatory initiatives in the financial sector rightly aim to ensure that banks are once more subject to the same liability principle as any German Mittelstand company.

Transferring liability and control to the European level is not a new idea. When the treaties were signed, some saw the monetary union as merely an interim step towards a political union. Addressing the Bundestag here in Bonn in November 1991, Helmut Kohl remarked that "the idea of sustaining economic and monetary union over time without political union is a fallacy".

There are a wealth of proposals as to how liability should be shared. By saying that "is now high time to reinforce [the] foundations", the five presidents, too, are aiming to establish joint liability and risk-sharing. However, when it comes to the necessary transfer of fiscal sovereignty, practically no concrete proposals have been made. Although the five presidents wrote that "a genuine Fiscal Union will require more joint decision-making on fiscal policy," they are relatively short on specifics – which is understandable. After all, there is next to no political support for the transfer of fiscal sovereignty to the European level.

The parliamentary group of the SPD recently adopted a paper on the future direction of monetary union which calls for new executive powers at the euro-area level in the medium term in order to monitor the fiscal rules and national budgets. This recognises the need for a balance between liability and control. I do not, however, perceive any broad-based willingness to relinquish sovereignty, let alone the majorities for the constitutional and treaty amendments which that would require. On the contrary, national politicians get very touchy about warnings from Brussels and reject any interventions in their fiscal autonomy. For instance, Matteo Renzi,

whom I have already quoted, says that Italy will not allow a "bureaucrat from Brussels" to dictate its fiscal policy.

In any event, a halfway solution – along the lines of increased joint liability while leaving national sovereignty in financial matters as it is – would undermine incentives for sound fiscal action. That would harbour the risk of monetary policymakers again being called to the rescue – and far too much has already been demanded of monetary policy in the current crisis.

As long as liability and control are not aligned at the European level, there is therefore only one way to stabilise the monetary union in the long run. That way consists in affirming the decentralised approach of the Maastricht framework and reinforcing the principle of national responsibility. At first, that may seem to be a case of looking backwards. But that impression is deceptive, because it is not about restoring the monetary union to its pre-crisis condition. Rather, the asymmetric Maastricht framework should be designed so as to make the structure stable without depending on a political union.

To do that, the binding force of the debt rules should be strengthened. Admittedly, that was precisely the objective of the last reform of the Stability and Growth Pact. However, it ended up conceding considerable discretionary scope, mainly to the European Commission. Torn in two directions in its dual role as a political institution and guardian of the treaties, the Commission is frequently inclined to compromise at the expense of budgetary discipline. This means that the binding power of the debt rules has ultimately tended to be weakened. A more consistent interpretation of the rules could have been achieved if responsibility had rested with an independent fiscal authority for budgetary surveillance instead of the Commission. Please note: an independent authority – a committee which only advises the Commission, as proposed by the Five Presidents, would fall short.

Past developments have made it abundantly clear that political agreements alone are not enough to ensure sound public finances. That was evidently also how the founding fathers saw the situation. By introducing the no-bail-out clause, they sought to allow the disciplining forces of the financial markets to come to bear. But that can only work if the no-bail-out principle is made credible. "Whoever reaps the benefits must also bear the liability." This liability principle, as once described by Walter Eucken, also needs to be applied to sovereign debt.

Investors have to perceive a credible threat of losing their money if they buy bonds from governments that have unsound public finances. The crisis has brutally exposed the fact that sovereigns, too, can reach the brink of insolvency. An orderly procedure for a sovereign default does not yet exist, however. But that is precisely what we need. This is not only about procedural rules, however. It is also about a sovereign default not being allowed to jeopardise the stability of the entire financial system. To a certain extent, the terror has to be taken out of sovereign debt restructuring. Doing this means, in particular, loosening the close links between banks and sovereigns. This is because, at present, a considerable part of sovereign debt is held by – mostly domestic – banks. Therefore, if a government no longer serviced its debt, the banks, too, would encounter massive economic difficulties. Financial stability would be under threat.

One reason for the large holdings of sovereign debt on the banks' balance sheets is that, unlike in the case of loans to enterprises and households, banks currently do not have to hold any capital against euro-area government bonds. The idea behind this is that euro-area bonds are believed to be risk-free. Upon the outbreak of the sovereign debt crisis, if not beforehand, it had become clear that this assumption was a fiction with no basis in reality. For that reason, there must be an end to the preferential regulatory treatment of government bonds. Giving banks an incentive to maximise their sovereign debt holdings instead of lending to the private sector is, after all, absurd.

We have come a long way over the past few years towards making the financial system more robust. In particular, banks now have to satisfy higher quantitative and qualitative capital requirements, which has improved their ability to absorb losses. But, to date, no decisions have been taken with regard to cutting back the regulatory privileges of government bonds. The

Bundesbank has been calling for this for a number of years now; the fact that it is now being negotiated at the global and European levels can be regarded as a success.

The inherent risks of the strong economic links between sovereigns and banks have to be limited and, until the key decisions have been taken on this issue, a European deposit protection scheme would be premature. What argues against an over-hasty communitisation of deposit protection – which the Commission and some member states are calling for – is, not least, the fact that the member states still hold considerable sway over the quality of bank balance sheets, say, by virtue of national insolvency law. Here, too, it holds true that liability and control have to be aligned with one another. It is inconsistent to claim national sovereignty while at the same time calling for more European solidarity.

5. Conclusion

Europe is therefore still facing major challenges. A large number of fundamental decisions aiming at more economic growth and a durably stable monetary union still have to be taken. The sooner they are taken, the better. Having said that, the description "durably stable" has two sides to it. What has to be "durably stable" is, first of all, the regulatory framework. This will only be possible once liability and control are in alignment and once solidarity and sovereignty are in balance. Public finances, too, have to be "durably stable", however. This is because a monetary union is stable only if each country keeps its own house in order; this has been made abundantly clear by the repeated discussions on financial assistance for Greece.

This was something that was pointed out in a speech delivered here at your club, La Redoute, more than 25 years ago. The former Bundesbank President Hans Tietmeyer was already aware of the pitfalls back then and said that "Without sufficient stability policy convergence and, above all, greater budgetary discipline in a number of European countries, economic and monetary union will be unable to gain a sustainable foundation. No matter what fine words and ambitious statements of intent are contained in the treaties, it will not be enough if there does not exist the will to actually change fiscal and budgetary policy itself."

Once we in the euro area have reached the point where balanced budgets are actually firmly anchored in policy, tenths of a decimal point will indeed probably no longer be important for confidence in the euro.

Thank you for your attention, and I look forward to your questions.