Jens Weidmann: Exercising responsibility - how monetary union can be made future-proof

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 Austrian Society for European Politics, Vienna, 6 July 2017.

* * *

1. Welcome

Ewald
Mr Liebscher
Ladies and gentlemen

Thank you for inviting me to Vienna. It gives me great pleasure to talk about Europe with you this evening.

It's always a delight to pay a visit to Vienna – not just because it's such a remarkably beautiful city, but also because of the exceptionally good cooperation between the Bundesbank and Austria's central bank, the Österreichische Nationalbank. It's a relationship that goes back decades and whose importance we recently underlined by convening a joint board meeting.

Though I've visited Vienna so many times, I've never once managed to visit one of the city's true landmarks, the giant Ferris wheel in the Prater public park. This attraction, incidentally, is celebrating its 120th birthday this year.

Yet as an economist, I'd do well to take a ride on Vienna's famous Ferris wheel – after all, economists are keen to take a bird's eye view of developments – at least that's what I've been told. That can be a good way of broadening one's horizons and seeing things in the right perspective. But an aerial vantage point doesn't always make argumentation any easier because it sometimes means that key details go unnoticed. And one notable such detail, I have found, is the institutional framework, which I will be returning to later in my speech.

I came here today to share my thoughts on the euro area and on ways in which monetary union can be made future-proof.

My speech this evening will begin by casting a glance at the economic outlook and the monetary policy stance, before moving on the responsibility incumbent upon governments to foster sustained economic growth. And I will conclude by discussing a number of proposals for changes to the euro area's institutional architecture – changes which I feel are necessary if the euro area is to be preserved once and for all as a union of stability.

2. The economy

Ladies and gentlemen, the euro-area economy has been expanding for 16 consecutive quarters now, and anyone looking at the purchasing managers' index of late will even have come across headings like "Firms barely coping with demand". The upswing, then, is turning out to be increasingly robust, and it has now spread to pretty much every single euro-area country.

Growth also picked up distinctly in France and Italy recently, so the divergence observed in the GDP growth rates of the euro area's three largest countries over the past three years has come to a halt, at least. It's perfectly normal, of course, for economies in the euro area to differ to a degree, but stubbornly heterogeneous economic paths certainly make life difficult, not least for monetary policymakers. Monetary policy does, after all, need to be geared to the euro-area average, and if growth rates are scattered too broadly, we end up tailoring a monetary policy

garment that doesn't really fit any member state.

Consistent with the prospect of a continuing recovery, the ECB staff nudged their June growth projection a little higher, to 1.9% this year and 1.8% in 2018. And the ECB Governing Council agrees unanimously that the risks to the economic outlook throughout the forecast horizon are now largely balanced.

The inflation rate, too, has risen sharply over the past twelve months. Saying that, the rate of inflation has mainly gained traction because energy prices have climbed substantially on the year. But with oil prices leaning somewhat to the downside of late, the energy component is unlikely to add any further inflationary pressure. That is why inflation rates look set to return to a slightly lower level at year-end.

This is partly because domestic price pressures are still relatively subdued. One measure we use to gauge domestic price pressures is the inflation rate with energy and food price increases stripped out. This core rate of inflation, as it is known, is currently just over 1%.

Yet another point on which the Governing Council agrees unanimously is that domestic price pressures in the euro area will likewise pick up over time – not least as labour market conditions continue to improve. Unemployment has dropped substantially since the crisis was raging and, at 9.3%, it's now just one percentage point, more or less, above the pre-crisis average. And as for employment, more people in the euro area are in work today than before the crisis.

But for all this predominantly good news from the labour markets and the increasing utilisation of production capacity, wage growth is stubbornly refusing to pick up pace. To some extent, this is down to the labour market reforms adopted in the past and the rising level of labour force participation which have been dampening wage growth. Plus there is evidence to suggest that wage- and price-setting behaviour during the crisis evolved towards a state where the inflation rate is currently less responsive to shrinking slack than it was in the pre-crisis era. But that most certainly does not mean that the Phillips curve, as it is known, has flattened out for good – this is a point which Mario Draghi also highlighted recently.[1] And incidentally, I share his view that as the economy continues to pick up and stimulate greater demand, there will also be greater scope for passing through prices and thus for mounting price pressures as well.

But for now, an accommodative monetary policy stance is the right calibration for bolstering economic recovery and thus for strengthening inflationary pressures in the euro area – that's another point we agree upon in the Governing Council. There are, however, different opinions as to how strongly we need to step on the monetary policy pedal and what instruments we should use.

It won't come as a shock to you that I'm more sceptical than many of my Governing Council colleagues, especially when it comes to government bond purchases. In essence, I am concerned that purchases of government bonds might blur that all-important boundary in a currency union – the one dividing monetary policy and fiscal policy. Eurosystem central banks have now become the euro-area countries' biggest creditors. At the end of the day, this can lead to political pressure being exerted on the Eurosystem to maintain the very accommodative monetary policy for longer than appropriate from a price stability standpoint. After all, in the context of asset purchases, changes in monetary policy impact more directly on governments' funding costs than they do under normal conditions. And that's naturally also problematical in view of the disciplining effect of the capital markets on government finances because at the end of the day, sovereigns pay pretty much the same rate of interest on our holdings of assets, regardless of their credit quality.

Hence my view that government bond purchases are an instrument of last resort – one which should mainly be used to fend off deflation. But I've said in the past that the fears of deflation are overblown. They've now become even less of an issue, and the Eurosystem's price projections

reflect as much, of course.

At any rate, the credibility of monetary policy hinges on monetary policy accommodation coming to an end once the time is right from a price stability perspective.

The ongoing economic recovery is now opening up the prospect of a normalisation of monetary policy. It's not a question of slamming on the brakes – to stay with the imagery I used earlier on – but of taking our foot off the accelerator a little. Both the timing and the pace of monetary policy normalisation depend on the extent to which price pressures are sustainable and self-sustaining.

I'm well aware that savers feel pinched by the accommodative monetary policy and the low interest rates. But monetary policy isn't the only variable that has a bearing on interest rate levels – real long-term interest rates over the economic cycle also depend to a large extent on trend growth. A persistently higher rate of economic growth in the euro area not only helps to ease the pressure on monetary policy because it drives up equilibrium interest rates and thus widens the gap to the zero lower bound on interest rates. It would also represent an opportunity for more people to benefit from rising prosperity and for Europe to once again deliver on its promise of welfare.

Yet the longer-term outlook for growth in the euro area is looking cloudy, not least because of the looming burden of demographic change in the euro-area countries, of which Germany looks set to bear the brunt. That is why adding momentum to the forces of growth must be at the heart of the euro-area countries' endeavours.

Monetary policy cannot bring about that kind of stronger economic growth – it's an objective that only smart fiscal and economic policy, such as structural reforms, can achieve. Yet the willingness to embrace reform has dwindled quite substantially overall since the sovereign debt crisis came to a head – and the International Monetary Fund is not alone in highlighting this issue.[2]

Needless to say, the euro-area countries are each starting out from different positions, with their own particular economic structures, so it would be wrong to pursue a "one size fits all" approach. That said, I am convinced that measures that strengthen public finances and help produce competitive economic systems would also stimulate growth and also enable the benefits to be more widely shared. For one thing, competition among businesses encourages them to innovate, boosting economic growth.[3] For another, studies show that there is a level of government debt above which economic growth is stifled.[4]

There's no lack of reform proposals. Recommendations are in abundant supply, not just from the European Commission, but from other national and international organisations as well.

Germany, too, is facing major challenges. It needs to ready its social security systems to withstand the challenges posed by demographic trends, push labour force participation higher still, and step up investment in education so that those in work are more productive and less at risk of losing their jobs, plus it will have to expand its digital infrastructure.

But aside from these major challenges, IT-related productivity gains can also be harnessed on a smaller scale, such as in the country's public administration, which is another area which has some catching up to do in the deployment of digital information and communication technology. For instance, to apply for a German ID card, you still have to turn up in person at your local municipal administration office.

Regrettably, very little progress has been made on this score, as a recent European Commission report on the digital economy and society in the EU member states confirms. Germany ranks a meagre 20th for its public services, while Austria occupies a far-superior sixth place.

The European level still has a great deal of unharnessed growth potential of its own, however. The EU Single Market has been a success story, but the tale isn't over yet. One huge step forward would be the completion of the single market for services, because unlike the single market for goods, trade in services is still subject to national barriers.

The forces of growth would also be given a shot in the arm if the Single Market switched wholesale to digital goods.[5] Europe's markets for digital goods remain heavily fragmented, especially where the protection of privacy, copyright, and liability issues are concerned.

Yet businesses would reap rewards not just from a complete single market but also from broader funding opportunities. This is where the capital markets union comes into play.

European businesses still mainly use bank loans as their chief source of funding. Harmonising regulation or, for example, boosting investor protection in the venture capital market might make it easier for businesses to source equity capital on a larger scale. Not only would that broaden enterprises' funding options; it would also make them more resilient to economic shocks. That's because equity capital absorbs losses, while debt capital still needs to be serviced in full, even when times are hard, if a company is to fend off insolvency.

What is more, research for the United States reveals that private risk sharing via integrated capital markets is far more conducive to cushioning shocks that public risk sharing, which is the main talking point in Europe. The integrated capital markets in the United States absorb something like 40% of the overall cyclical fluctuations between the US federal states – fiscal policy just between 10% and 20%.[6] If a negative shock hits an industry or a specific region, then losses are spread widely beyond the region affected if a business's shareholder base is spread across many different states. And that works in the other direction, too, of course – during upturns, investors benefit from the investment opportunities in other states.

So there are plenty of ways in which economic growth at the European level can be stimulated by embracing the right reforms. I do, however, see the risk that the exit negotiations which have now kicked off between the EU and the UK will absorb so much political attention among European decision-makers that little scope will remain for other major projects. Which makes it all the more important for the member states to embrace reform with renewed vigour. On this score, the announcements made by the new French president are a positive sign.

3. Taking the institutional architecture of monetary union to the next level

Ladies and gentlemen, the economic recovery may be robust, but that shouldn't blind us to the continued vulnerability of European monetary union.

One fundamental stumbling block existed from day one because of the euro area's asymmetric design. Member states surrendered their sovereignty in monetary policy matters to the ECB, but retained ownership of their fiscal and economic policies.

This construction makes the monetary union potentially vulnerable because the crisis showed that at the end of the day, the euro area as a whole had no option but to cushion unsound developments in individual member states if it was to prevent the stability of the entire union from being jeopardised.

In any case, there is less of an incentive to run a sound fiscal policy in a currency union because the consequences of member states accumulating excessive levels of debt can be passed on in part to the community.

In a currency union, the interest rate hike for a highly indebted country is smaller than it would be if it had its own independent currency. By the same token, however, rates also edge a little higher for all the other member states as well – not to mention the stability-jeopardising situation that

would arise if that country even ended up brushing with insolvency.

This phenomenon is known as the “common pool problem” in economic theory, and overfishing is often used to explain it. A single fisherman who catches too many fish leaves fewer behind for others in his profession and ultimately jeopardises the long-term sustainability of fish stocks. Overfishing, then, is dangerous for the fishing community. But an individual fisherman is out to net as many fish as possible, ignoring the interests of other fishermen or future generations of fishermen.

This is arguably one reason why historian and winner of the 2017 Charlemagne Prize Timothy Gordon Ash described the story of monetary union so far as a “crisis foretold”.

Yet that remark isn’t really entirely fair to the founding fathers of monetary union, who most certainly did have their eye on the particular incentive to run up debt. Their idea was that a combination of market discipline and fiscal policy would keep fiscal policymaking on a sound basis.

That, of course, is why a no-bailout clause was built into the Maastricht Treaty contains to prohibit member states from assuming each other’s debts. And it also bans monetary financing of government debt by the Eurosystem. Together, the thinking goes, these safeguards would ensure that investors themselves – and not other parties such as the taxpayer – would bear the risks of investing in government bonds.

The Treaty also contains rules which curb government debt and fiscal deficits, not only to ensure that public finances remain on a sustainable path, but also to pave the way for the automatic stabilisers to function when the economy experiences a downturn or even, if need be, to provide sufficient leeway for active fiscal policymaking without raising any doubts over the sustainability of debt. These rules bolster the principle of individual national ownership of fiscal policy upon which the Maastricht Treaty is founded.

Walter Eucken, founder of the Freiburg school and a pioneer of the social market economy, condensed this liability principle, as it is known, into a simple formula: “Whoever reaps the benefits must also bear the liability.” And what goes for the economy goes for countries as well: decisions will only ever be taken responsibly if those who decide also bear responsibility for the consequences of their actions.

Thus, the Maastricht Treaty largely assigned the power to act and liability in matters of economic and fiscal policy to the member states.

Yet the safeguards I have just mentioned were unable to prevent government debt from ballooning in a number of euro-area countries. This was partly due to repeated breaches of the fiscal rules – incidentally by Germany too, shortly after the launch of monetary union – which the capital markets failed to punish by demanding higher risk premiums because the no-bailout clause lacked credibility. But another reason for the ballooning debt levels was undoubtedly the financial crisis, which saw a number of euro-area countries being forced to shore up their banking systems.

This was compounded in the subsequent sovereign debt crisis by emerging doubts over debt sustainability in some member states. Rescue measures were swiftly rolled out to prevent the crisis from coming to a head.

These measures, however, did not make monetary union crisis-proof once and for all. Quite the opposite, in fact. By adding further elements of mutual liability, they softened the principle of independent responsibility.

Since economic and fiscal policy matters continue to be issues of national ownership, the

relationship between actions and liability has got out of kilter.

The euro area will only ever be crisis-proof once and for all if renewed importance is attached to the liability principle. There are two ways in which this can be achieved. Either through deeper integration, ie a situation where every member state surrenders decision-making powers in fiscal and economic policy matters to the European level, or by returning to an overhauled Maastricht Treaty, which would mean more national ownership and each member state being liable for the decisions it takes.

The first solution is the road to a fiscal union with centralised decision-making powers. While a fiscal union would not guarantee sound fiscal policymaking, it could curb the propensity to run a deficit I mentioned earlier this evening.

Former German Federal Chancellor Helmut Kohl, who sadly passed away recently, was already a firm believer that monetary union was merely one step on the path leading to political union. Addressing the Bundestag in November 1991, he remarked that “the idea of sustaining economic and monetary union over time without political union is a fallacy”.

Genuine political union proved unfeasible back in the early 1990s, however, and it appears to me that little has changed in this regard since then. Not least because the necessary transfer of sovereign rights would require comprehensive changes to be made to the EU Treaty and national constitutions.

It would appear, then, as though option number two stands a more realistic chance of restoring the balance between actions and liability. That would mean reinforcing the principle of individual national responsibility.

Only when sound finances are assured in this way and countries are no longer drifting apart economically will there finally be an ebbing of the pressure on the Eurosystem to intervene constantly as a firefighter. And only then will the financial markets do their job of taking adequate account of risks in their lending activity.

But what would have to change for the monetary union’s regulatory framework to function better than it has done in the past?

As long ago the 17th century, Blaise Pascal, the French mathematician, physicist, inventor, writer and theologian, noted that all good intentions already exist in the world, they only have to be applied.

In my opinion, the same thing could also be said about the fiscal rules in the euro area. They have been around for a long time; now they also have to be applied consistently.

The latest reform of the Stability and Growth Pact had the aim of strengthening the binding force of the rules on debt. In actual fact, it created considerable discretionary scope, mainly for the European Commission. We also point this out in our current Monthly Report.[7] And the Commission has already exploited this scope on several occasions and invariably interpreted the rules very generously in doing so.

The Commission’s dual role as guardian of the EU treaties, on the one hand, and, on the other, as a political institution concerned with striking a balance between the various policy interests of the member states, has undoubtedly played a part in comprises having been reached time and again at the expense of budgetary discipline. Some euro-area countries have been breaching the rules for nine years now.

Werner Schneyder, the Austrian comedian, once characterised the situation accurately as Europe consisting of countries that didn’t want to be told to do what they had decided to do

themselves.

What is needed to strengthen the fiscal rules is a simple and transparent design and implementation of the rules. An independent institution taking over responsibility for fiscal surveillance from the Commission would be a key step towards a less political approach. At least, that would clearly show where unbiased analysis ends and political concessions begin. For that reason, the Bundesbank suggests strengthening the role of the European Stability Mechanism (ESM) in fiscal surveillance, for example.

One thing does seem obvious to me, however. If member states retain their fiscal autonomy, the sustainability of public finances cannot be safeguarded by rules alone.

It is therefore essential that the binding force of the rules is additionally shored up by the disciplining effect of the market. In other words, interest rate levels have to be aligned more strongly again with the risks in government budgets.

The only way to achieve that, however, is if the no bail-out clause in the Maastricht Treaty gains more credibility again. Investors have to perceive a more credible threat of losing their money if they buy bonds from governments that have unsound public finances. One proposal put forward by the Bundesbank thus envisages changing the contractual terms for sovereign bonds in the euro area by introducing an automatic maturity extension for them as soon as the issuing government applies for an ESM programme.

Up to now it has been the case that a large part of the assistance loans are being used to pay off the original creditors. This means that the original creditors, such as banks, are then let off the hook – at the expense of taxpayers.

Extending maturities, on the other hand, would leave them on the hook, and they could be still held liable in the event of a later debt restructuring. In an emergency, it can be very difficult to tell for certain whether a debtor is temporarily illiquid or actually insolvent. An automatic extension of maturities, however, would allow the ESM significantly more time to give careful consideration to the question of debt sustainability – and without releasing the original creditors from liability during this period.

A maturity extension would have the added advantage of substantially reducing the need for financial aid under an ESM programme. It would also broaden the range and scope of the existing rescue mechanism. Had an automatic maturity extension had been available to us in 2011, for example, Portugal would have needed only about €43 billion to cover its entire budget deficit until 2014 rather than the €76 billion in total it received in assistance loans.

However, restructuring sovereign debt would be a realistic option only if the financial system could also cope with a haircut. That’s because not much would be gained by bringing the financial system to its knees. There would also be an incentive for the community of states to step in for private creditors.

For that reason, the close link between banks and sovereigns that exists in the euro area has to be severed. Experience of the crisis years has shown that – especially in times of crisis – banks have a big appetite for sovereign bonds, preferably bonds issued by their own government.

Banks’ appetite for government bonds would indeed be curbed if they had to back sovereign issues on the books with capital in future like they have to do with private loans. Unlike in the case of corporate bonds, euro-area financial institutions are not required to hold capital against government bonds in order to cover potential defaults. And there are also no upper limits on how many government bonds the banks are allowed to buy. The regulations still treat sovereign bonds as risk-free, even though the euro-area debt crisis clearly revealed that this assumption is not accurate.

Banks will be able to cope with the restructuring of sovereign debt only when banks hold sufficient capital against government bonds and a limit is placed on the size of individual exposures. And only then is there also likely to exist the political will to take such action.

4. Sovereign bond-backed securities

One advantage of abolishing the preferential treatment of government bonds would be giving banks incentives to further diversify their sovereign bond portfolio and, thus, their credit risk. That would represent a major contribution to severing the sovereign-bank nexus that served to fan the flames of the crisis.

Many fear that abolishing the preferential treatment of sovereign bonds might result in a lack of safe assets. For that reason, Markus Brunnermeier and his colleagues have proposed the creation of what are known as "sovereign bond-backed securities".[8]

The aim of the proposal is to increase the range of AAA-rated bonds in the euro area. To this end, two tranches of a new type of securities are to be issued. Both tranches are to be collateralised with sovereign bonds of all the euro-area countries.

Losses from the sovereign bonds would initially occur in the junior tranche. As a result, the senior tranche is intended to be especially safe. And that is why this tranche is designated in the proposal as "European Safe Bonds", or ESBies for short.

In principle – and depending on how it is designed – this model could indeed help make it easier to diversity portfolios. It is highly uncertain, however, whether this would have the hoped-for impact on the available range of safe forms of investment.

The rating agency Standard and Poors, for example, points out that the risk of defaults on sovereign bonds is highly correlated.[9] If a country is struggling to service its bonds, it is probably not the only one.

That is why the risks of euro-area sovereign bonds cannot be be so easily diversified. At least Standard and Poors does not anticipate that ESBies would gain the secure AAA rating. Under such circumstances, the supply of secure assets in the euro area might become scarcer, not more abundant

Above and beyond that, the proposal leaves a number of further open questions. Only when such questions have been answered will be it possible to assess what implications the introduction of sovereign bond-backed securities would have for the functioning of the national sovereign debt markets.

Furthermore, it would be necessary to rule out the possibility of such securities leading to greater mutual liability. Such a development would further undermine individual national responsibility in the euro area – with all the problems I have already discussed.

It would therefore have to be ensured that sovereign bond-backed securities are issued only by private financial market players – and certainly not by a European debt agency that potentially possesses a government guarantee.

One simple fact cannot be avoided either. Risks don't disappear just by packaging them; they simply become concentrated in junior tranches – we learned that much from the subprime crisis.

That is why the banks have to back all tranches of securitisation in a risk-appropriate manner with capital in future. There should be no preferential treatment of sovereign bond-backed securities compared with sovereign or private bonds. That is because preferential regulatory treatment would encourage a mispricing of sovereign default risks and thus harbour a further risk

to financial stability.

Notwithstanding such unanswered questions, if there were a desire to persist in separating sovereign bonds into safe and less safe components, the obvious thing to do would be for each government to package its own bonds into different tranches so that especially safe national securities would then be created.

5. Concluding remarks

Ladies and gentlemen

You can look at it from any angle, and you can't avoid one fact. Sovereign default risks cannot be eradicated by packaging sovereign bonds or by splitting up bonds into safe and less safe tranches. Safe opportunities for investment can only be created by the member states themselves by ensuring sound public budgets. This is best achieved by consistently implementing the liability principle.

I spoke about that at the beginning of my speech. Like riding on the big wheel, I've therefore almost come back to the point from where I started. That means it's time for me to get off. And, as everyone knows, when someone gets off the big wheel, places become available for new passengers.

Stefan Zweig once remarked that thoughts thrive just as much on affirmation as on contradiction.

That doesn't just apply to the Governing Council of the ECB but also to the discussion on which we are now embarking.

Thank you for your attention.

---

1 M Draghi (2017), Accompanying the economic recovery, Introductory speech at the ECB Forum on Central Banking, Sintra, 27 June 2017.

2 www.oecd.org/eco/goingforgrowth.htm

3 M J Melitz, The impact of trade on intra-industry reallocations and aggregate industry productivity, Econometrics, Vol 71, 2003, pp 1695–1725.

4 S Cecchetti, M Mohanty and F Zampolli (2011), The real effects of debt, BIS Working Paper No 352.

5 European Commission (2015), A digital single market strategy for Europe – analysis and evidence. SWD(2015) 100 final.

6 P Asdrubali, B E Sørensen and O Yosha (1996), Channels of interstate risk sharing: US 1963–1990, Quarterly Journal of Economics, 111(4), pp 1081–1110.

7 Deutsche Bundesbank (2017), Design and implementation of the European fiscal rules, Monthly Report, June 2017.

8 Brunnermeier, M, S Langfield, M Pagano, R Reis, S Van Nieuwerburgh, and D Vayanos (2016), " ESBies: Safety in the tranches", European Systemic Risk Board Working Paper No. 21

9 S&P Global Ratings (2017), How S&P Global Ratings Would Assess European "Safe" Bonds (ESBies). RatingsDirect.