Andreas Dombret: The future of Europe and the euro – what monetary policy can and cannot do

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the University of Pretoria, Pretoria, 14 August 2017.

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Ladies and gentlemen,

Amongst economists there is an old saying: "When America sneezes, the world catches a cold". In fact, this saying is now so commonplace that it is impossible for me to trace its origins. Over the years, countless variants have been invented. If you look it up on the internet you will find that the same has been said about Germany, China and many other countries.

In my view, the fact that this saying has become so widespread does not mean that the world has become an unhealthier place or that economic commentators lack inspiration. What it does say is that the world has become increasingly interdependent over the past decades.

With more and more goods being transported from one continent to another and with ever more capital flowing freely across borders, what happens on one side of the world very much matters to the other, and vice versa.

And this brings with it a need to engage in dialogue, to exchange views about local developments and global challenges.

So let me first and foremost thank the South African Institute of International Affairs and the Chair of Monetary Policy here at the University of Pretoria for providing me with this opportunity for such dialogue today.

I believe one issue currently being discussed in many countries is whether the successful role that central banks around the world have played in mitigating the consequences of the financial crisis might, in the long run, undermine the pillars of their success. And this question certainly is not confined to just the advanced economies, which have seen the largest central bank interventions in the past few years.

But before I get to that topic, I will first say a few words about the economic situation in the euro area.

1. Economic situation in the euro area

Policymakers in Europe learned what increased global interdependencies meant during the past few years when they had to deal with the sovereign debt crisis. The poor economic performance in Europe contributed to the world economy not recovering as fast as some wished.

So whenever I attended international policy meetings, I was pressed on what solutions European policymakers had in store for solving the crisis.

I always responded that the only sustainable solution was to correct the macroeconomic imbalances in the euro area, and that this adjustment process would take some time.

After all, the sovereign debt crisis was not least the result of a slow but steady loss of price competitiveness in some countries in the euro area. The loss of competitiveness went hand in hand with a build-up of excessive foreign indebtedness – partly due to high public deficits and partly due to high deficits in the private sector.

When the markets began to doubt that these debts could be repaid, they pulled the plug. Some countries in the euro area were effectively shut off from the capital markets. In countries where the reason for the sudden stop was not already a fiscal crisis, it soon became one as sovereigns struggled to rescue their banking systems.

To regain the trust of the markets, the affected countries had to undertake reforms to regain competitiveness. But regaining competitiveness takes time. Time that these countries did not have.

The situation was calmed down after the member states of the euro area hastily tailored a rescue fund which has now become a permanent institution, the European Stability Mechanism.

The Euro system – i.e. the ECB and the national central banks of the 19 member states of the Euro area – also needed to take measures to prevent the crisis from escalating. These included targeted purchases of bonds from member states with poor credit ratings. Some of these measures not only proved controversial within the ECB Governing Council, but also raised a number of fundamental questions about the limits of monetary policy.

These emergency measures bought the countries time to restore their competitiveness and to consolidate their public finances. Most of the former crisis countries have indeed managed to reduce or even eliminate their current account deficits. But the wage restraint that was necessary to improve price competitiveness together with the ongoing efforts to consolidate public finances have dampened growth and price pressures in the euro area.

This is one of the reasons why the recovery after the financial crisis took somewhat longer in the euro area than in other advanced economies, such as the United States and the United Kingdom.

But for some time now, the recovery in the euro area has become increasingly robust and broad-based. Real GDP has been growing now for 16 quarters. And what is probably equally important, almost all countries are sharing in the recovery. There has recently been an improvement in growth in France, Italy and Spain, for example. This means that growth in the large euro area countries is no longer diverging.

The economic outlook has improved, too. The European Central Bank, for example, has raised its forecast for the euro area slightly – to 1.9% for this year and 1.8% for next year. The International Monetary Fund even expects the euro area economy to grow by 2.1% this year as well as next year.

The outlook for Germany is similarly positive. The current projection of the Bundesbank expects the German economy to grow by 1.9% this year and 1.7% in 2018. But this projection is still from April. Since then, key economic indicators have performed strongly. So I wouldn’t be surprised if, in the end, growth this year would turn out to be somewhat higher.

And there is a growing consensus that downside risks to this outlook have receded such that overall risks are now more balanced.

Within the ECB’s Governing Council, the improved economic outlook has led to a consensus that price pressures are expected to increase, too. In addition, there is consensus that the spectre of deflation has now disappeared. This is reflected in the current projection of the ECB. Its economists expect prices in the euro area to rise by 1.6% at the end of the forecast horizon in 2019.

These are important conditions on the route to a normalisation of monetary policy. However, the signs of a sustained turnaround in terms of inflation are muted, so far. There is therefore a broad consensus on the whole that an expansionary monetary policy is very much justified. Where

perspectives do differ, though, is on how strongly the ECB should step on the monetary policy pedal and what instruments it should use.

But while the situation is improving, the euro area has not yet returned to full strength. The comprehensive emergency measures to which politicians and the Eurosystem resorted have prevented the crisis from escalating, but they have not yet made the euro area durably stable.

So at the moment, discussions over further reforms of the euro area are continuing. The main question in these discussions is how to balance fiscal and economic self-responsibility with solidarity.

2. The role of central banks

But that is not my main topic today. Rather, allow me to point out that the major role that central banks played, first in containing the immediate effects of the financial crisis and then in drastically easing financial conditions to stimulate demand, must not lead to an overburdening of central banks.

This is not only an issue in the euro area. The ultra-loose monetary policy that had been enacted by many large central banks since the outbreak of the financial crisis certainly prevented a sharper downturn at the time and contributed to the recent improvement of the global economic outlook.

But this was not without consequences. By introducing unconventional measures, such as long-term refinancing operations or assets purchases, central banks have begun to intervene ever deeper in financial markets.

Both the Bank of England and the US Federal Reserve have expanded their balance sheets from roughly 5% of GDP in 2008 to more than 20% in 2017. During the same period, the ECB has increased its balance sheet from roughly 15% of GDP to more than 40%. In Japan, the corresponding increase was from 20% to 90%.

My impression is that, since the onset of the crisis – which is to say first the financial and economic crisis, then the sovereign debt crisis – more and more is being expected of monetary policy. When it comes to the euro area, some even see the ECB as the only player capable of taking action.

In any case, the actions of central banks have been brought much more to the forefront of media and political interest since the financial, economic and debt crisis.

In 2015, for example, the annual meeting of central bankers in Jackson Hole was met by demonstrators, and they came from both ends of the political spectrum. At one end, there were those demanding that monetary policy do more to kick-start the economy, and at the other end, those who were protesting against central banks interpreting their mandates too broadly and pursuing a policy of cheap money.

And in the euro area, historically low policy rates and the extensive asset purchase programmes have led some to discuss whether and in what way monetary policy affects the distribution of income and wealth.

Upon closer examination, the claim that very low interest rates increase in-equality by driving up asset prices is somewhat too straightforward. This is because low interest rates prop up the economy, thereby leading to greater job security and higher wages. Furthermore, they relieve pressure from public finances. This benefits taxpayers. It is therefore rather doubtful that the accommodative non-standard monetary policy measures of recent years have caused inequality to increase overall. In any case, such was the finding of an analysis published by the

Bundesbank in our 9/2016 edition of our Monthly Report.

I have the impression that discussions like these seem to start spreading to other countries that are not even making use of non-standard measures.

At least I understand that, in South Africa, too, some are calling for a more expansionary monetary policy in order to support socio-economic transformation. I am following all these developments with some concern.

This year, the Bundesbank is celebrating its 60th anniversary. This occasion has also provided us with an opportunity to take a look back at the 1970s, when many of the advanced economies were plagued by double-digit inflation rates.

One reason for this malaise was the prevalent economic thinking of that time. The belief in many countries was that cheap money could be used to fight rising unemployment.

It was German chancellor Helmut Schmidt who famously put this thinking in a nutshell: "I would rather have 5% inflation than 5% unemployment," he once said.

This view was met with opposition in the Bundesbank. Former Bundesbank President Otmar Emminger once warned: "If you flirt with inflation, you'll end up marrying it."

And unfortunately, that's precisely what happened. In many countries, rising unemployment was caused by structural factors – and there was little that monetary policy could do about these. The attempt to use accommodative monetary policy to tackle structural problems was bound to fail – and so it did. This resulted in high inflation rates and high unemployment – a phenomenon that later came to be known as stagflation.

Germany and Switzerland got through the 1970s with comparatively low inflation and unemployment rates. Politicians and central bankers in other countries gleaned from this that a stability-oriented monetary policy ultimately needs to be free from political interference and that central banks should set policy, first and foremost, with the goal of price stability in mind.

By that time, economists had arrived at this conclusion on purely theoretical grounds. Jan Tinbergen, who was later awarded the first Nobel Prize in Economic Sciences, had already argued back in 1952 that, for each policy target, there must be as many instruments as policy objectives.

For monetary policy, whose only instrument is the interest rate, the Tinbergen principle means that there may be also only one target: Price stability.

In the three decades prior to the outbreak of the financial crisis in 2007, many countries did indeed issue their central banks with narrower mandates geared towards price stability. At the same time, monetary policy-making institutions became more independent. Major central banks brought their models increasingly into line with that of the Bundesbank, which has always enjoyed a large degree of independence.

These developments peaked with the foundation of the ECB, with the Bundesbank's independence serving as its blueprint. This concept was successful, and it was possible to combat inflation in almost all of the advanced economies.

Independence and a narrow mandate for central banks are important achievements. The thought that these achievements might be questioned deeply unsettles me.

In a democracy, ceding control over monetary policy to a central bank can only be legitimised if the central bank is provided with a narrow mandate: to maintain stable prices.

Using monetary policy for other purposes entails risks to price stability and could, in the long run, lead to the independence of central banks being questioned.

Allow me to also mention a separate, but related, point. It would be wrong to conclude from the massive central bank interventions that we have observed in recent years that central banks can stimulate growth on a sustainable basis. Monetary policy cannot do that.

Monetary policy can stimulate or slow down the economy in the short term if this is required by the mandate to maintain price stability. Putting the economy on a higher permanent growth path, however, is something that central banks cannot achieve – even if they wanted to.

Only governments can put the economy on a higher permanent growth path – namely by implementing appropriate labour market, economic, as well as social and tax policy reforms.

Let me give you an idea of just what could be achieved by effecting the appropriate reforms. The IMF conducted a study to determine which OECD countries have the most growth-friendly tax regimes, labour markets and social insurance systems. IMF economists then calculated what would happen if euro area member states closed half of the gap to the leaders. The result was that annual euro area growth in subsequent years would be just under one percentage point higher.

3. Conclusion

Ladies and gentlemen, I started my short speech with a saying economists have about the world economy. There is also a saying about central bankers: The ambition of central bankers should be to be boring. It was coined by former Governor of the Bank of England, Mervyn King.

I hope I have not given you the impression that my ambition today was to be boring. And anyway, Mervyn King was not alluding to events like this but rather to the management of the economy. In my view, this also means that central banks should concentrate on maintaining price stability.

In one of his last interviews, former President of the Bundesbank Karl Otto Pöhl once put it like this: "A central bank must never be a political instrument. Politicians must accept that price stability is the main objective of central banks." Over the past few decades, great progress has been made in many parts of the world in the pursuit of stable prices.

Today, I have tried to highlight that this was due, not least, to the fact that many central banks have become more independent and have been given a narrow mandate. It is my sincere hope that this consensus continues. It is very much worth preserving.

Thank you very much for your kind attention.