Jens Weidmann: Containing the sovereign debt crisis – Germany's role and contribution

Special address by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the High-Level Public-Private Sector Conference, G-20 Agenda under the Mexican Chairmanship, Mexico City, 24 February 2012.

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1. Introduction

Ladies and gentlemen

First of all, I would like to thank Secretary José-Antonio Meade, Governor Agustín Carstens and Managing Director Charles Dallara for the invitation to deliver a speech to such a distinguished audience.

It is the second time since 2003 that Mexico has hosted the G20. A lot has changed since then, however. Emerging market economies, including Mexico, have significantly increased their weight in the world economy. At the same time, the role and the standing of the G20 have also changed appreciably. The G20's upgrade among the global fora is partly due to the worst financial and economic crisis in decades, which hit the world economy in autumn 2008.

Although this crisis largely originated in the advanced economies, it may also have significant implications for emerging market economies. For example, low interest rates in advanced economies can swell capital flows to emerging market economies, while distressed banks may curtail their cross-border investment. Moreover, an economic slump in the advanced economies squeezes emerging countries' export chances.

Mexico has assumed the G20 chairmanship at a time when the financial crisis, and in particular the sovereign debt crisis in the euro area, are putting a severe strain on global growth. Progress on the G20 agenda could contribute significantly to avoiding another global recession and to promoting sustainable global growth. I am very confident that the Mexican authorities will make this a successful presidency and I am looking forward to attending the G20 meetings during the Mexican chairmanship.

I would like to focus my remarks on what is currently still the most severe risk for global growth, namely the euro-area sovereign debt crisis. In particular, I would like to say something about the specifics of EMU – Europe's economic and monetary union – and the role of the euro area's major economic player Germany.

Let me start by correcting a popular misconception about Germany, namely the mistaken view that Germany, while itself managing to dodge the flames of the current crisis, is now selfishly refusing to come to the aid of the stricken countries by acting as chief firefighter.

Let us take a look at the facts. First, Germany is doing a great deal to help its partners. Thus the bulk of the containment measures rely heavily on Germany's financial support and hence its economic strength and fiscal soundness. Second, Germany is acutely aware of the need to tackle the root causes and not just the symptoms of the crisis. This is why it is pressing strongly for institutional reforms of the EMU framework plus structural reforms and budgetary discipline in the member states. By advocating this approach, Germany is not trying to force its own economic philosophy on others, but rather is living up to its responsibility to ensure a stable and sustainable monetary union.

2. The unique features driving the crisis – the specifics of EMU

Why is it that the euro area is suffering from a sovereign debt crisis while other big economies are not? The answer to that question lies in the specific features of EMU, which are also the key to understanding the current problems of the euro area. Weighted by GDP, the euro area as a whole is less indebted than the United States, and even Greece is less indebted than Japan. So what are the specifics of EMU that explain the difference?

The introduction of the euro eliminated exchange rate risks. This opened the way to welfare gains from stronger economic and financial integration. You pay with the same currency, no matter whether you are in Dublin, Helsinki, Lisbon or Rome. More importantly, the euro has proved to be a very stable currency – with a strong exchange rate and an annual inflation rate of about 2 % since its introduction.

But while enjoying the upside of a common currency and low inflation, the euro-area member states also have to contend with the downside that they can no longer offset lost competitiveness by depreciating. Instead, they need to adjust in real terms. And "to adjust in real terms" is a very technical description of what is usually a very painful process involving lower nominal wage growth or even nominal wage cuts. Another implication of the euro area's single monetary policy is that the key interest rates are set for the currency bloc as a whole. If this one-size-fits-all monetary policy poses problems in a particular member state, it must make compensatory adjustments in other policy fields. Otherwise macroeconomic divergences may arise. Looming credit bubbles, for example, have to be curbed by macroprudential measures or a more countercyclical fiscal policy.

Unlike the centralised monetary policy, fiscal policy and economic policy remained decentralised when EMU was launched. This, alongside the single monetary policy, is the key feature of EMU. Hence, even though member states are closely interlinked through the single market, trade and their financial systems, they nonetheless retain national autonomy over their fiscal policy and economic policy.

This combination of a single centralised monetary policy and a plurality of decentralised fiscal policies harbours some potential risks. Some of them were foreseeable from the start. One risk is the temptation for governments to overborrow because the economic costs of excessive public debt, for example higher interest rates, can be more easily shifted to other member states. A resulting loosening of fiscal discipline in individual member states can endanger the stability-oriented monetary policy. This potential problem can be greatly magnified by the possibility of shifting burdens between taxpayers of different member states via central bank balance sheets – without an explicit mandate from national legislators. This is an important difference compared with non-EMU central banks that have used their balance sheets as a policy instrument.

The forward-looking institutional safeguards put in place by the monetary union's founding fathers were laid down in the Maastricht Treaty and the Stability and Growth Pact (SGP). The Maastricht Treaty prohibits monetary financing and central bank lending to the public sector, stipulates a no-bail-out clause and spells out fiscal rules regarding deficit and debt ceilings. The respective excessive deficit procedures, including financial sanctions, are specified in the SGP. Moreover, it was expected that these formal checks would be reinforced by market pressure that would be sufficiently strong to discipline national governments.

However, the markets apparently did not fully believe in the enforceability of the no-bail-out rule, and they also disregarded the lingering risks in the member states. Therefore, the markets did not properly perform their expected policing function. Furthermore, the SGP rules were not taken seriously enough. Even Germany ran up excessive deficits for a few years and, even worse, championed a reform of the SGP which ultimately further weakened the application of the fiscal rules.

However, the EMU framework not only failed to avoid excessive deficits, it was also unable to prevent the build-up of macroeconomic imbalances within the euro area. In some member states, the sharp drop in interest rates after joining the euro was not used to increase productive capacities but instead was mis-used to fuel public and private consumption or domestic housing bubbles. The resulting increase in domestic inflation and wages eroded the competitiveness of the countries concerned and increased their dependence on capital imports. Furthermore, the institutional set-up turned a blind eye to increasing risks in the banking systems of some member states – the latter problem, of course, was not unique to EMU.

3. How the crisis started

The lax application of the fiscal rules by several member states meant that they entered the financial crisis with their public finances in bad shape, including large debt levels and high structural deficits. Investors now started to pay greater attention to persistent current account deficits and financial sector instability, and so they began to question the sustainability of the respective countries' public finances, focusing first and foremost on Greece.

Germany, by contrast, had taken a different path prior to the crisis. Structural reforms, in particular of the labour market, moderate wage agreements, the transition to a more flexible application of collective bargaining legislation and a clean-up of firms' balance sheets helped to restore the competitiveness of German companies. Putting this development into perspective, it should be borne in mind that the German economy had lost a lot of its competitiveness following the reunification boom in the early 1990s. Consequently, Germany was regarded as the "sick man of Europe" during the first few years after the introduction of the euro, given its poor growth performance and continuously rising unemployment.

The task of implementing the reforms and regaining competitiveness entailed significant political and social costs. However, these efforts, supported by a strong expansion in the global economy, allowed German growth to rebound after 2005. The country's strong economic performance helped to consolidate public finances. In 2007, Germany's general government budget was balanced, and unemployment had already fallen significantly. The German economy's high exposure to external demand made it vulnerable to the global demand shock of 2008–09. Nevertheless, the economy recovered very quickly from what proved to be the worst recession in post-war history, unemployment is still falling and employment has reached a post-unification high. Moreover, the negative impact of the sovereign debt crisis on the German economy seems to be rather limited so far. The upswing has become less dependent on external demand, while domestic growth drivers have gained in importance. Thus, a key lesson that Germany has learned from the past decade is that ambitious structural reforms to tackle entrenched domestic problems may be costly at first, but ultimately they pay off.

Although the German economy has lost momentum over the past few months, we expect GDP growth to pick up soon. This expectation is, of course, predicated on the assumption that the sovereign debt crisis will be overcome step by step and will not further intensify. So what has to be done to overcome the crisis?

4. Containing the crisis

When the sovereign debt crisis first emerged in Greece at the beginning of 2010, policymakers reacted swiftly with fiscal rescue packages and unconventional monetary policy measures. Alas, nearly two years on, the crisis is still with us and has even intensified. It has now spilled over from Greece to other countries. With regard to Greece, some progress has been made during recent weeks. Let me say that I fundamentally welcome the fact that the euro-area finance ministers came to an agreement on Monday regarding a second financial assistance programme for Greece. In order to achieve a turnaround and allow further assistance, it is now essential for Greece to deliver on the promises that have been made.

Ultimately, Greece cannot be forced to comply with the programme. But it should be clear that no further disbursements will be warranted if Greece fails to keep its side of the bargain.

A crucial requirement now is to prepare for the eventuality of a further escalation of the crisis by initiating appropriate ring-fencing measures.

The resilience of the banking system is to be increased by imposing additional capital buffers. The required size of these buffers has been determined through a stress test conducted by the European Banking Authority (EBA). It is now up to the banks, where necessary with the assistance of national government support schemes, to meet these requirements by the middle of the year.

Policymakers have responded by devising comprehensive measures to make the euro area less vulnerable. These measures include strengthening the European rescue mechanisms. It has been decided that the EFSF and the ESM will have a combined lending capacity of 500 billion euros. In March, euro-area political leaders will assess whether it is necessary to increase this firepower even further. Whatever the outcome is, a disproportionately large share of the financing of these rescue mechanisms is being and will continue to be borne by Germany by virtue of the country's top rating and the high degree of confidence it enjoys among investors.

The IMF has played an important role since the onset of the sovereign debt crisis – by co-funding assistance programmes, but also by contributing to a thorough analysis of the root causes of the economic weaknesses in the programme countries. EU finance ministers committed in December 2011 to providing additional resources for the IMF as part of a broader international effort. In this context and assuming that there is appropriate parliamentary support, the Deutsche Bundesbank, which manages the German contributions to the IMF, has pledged a new bilateral credit line of 41.5 billion euros to go to the IMF's General Resources Account. Hence, these resources will be available to all IMF members. In order not to violate the legal framework of EMU, the resources provided to the Fund must have all the characteristics of a reserve instrument. In particular, the IMF must not become a vehicle for monetary financing of government deficits.

Another issue that has been discussed in the context of ring-fencing is a stronger role for the Eurosystem in crisis management. However, this demand ignores the fact that the Eurosystem has already greatly contributed to containing the crisis via its various unconventional monetary measures. This has already stretched central banks' mandate significantly, and going even further would undermine the credibility of monetary policy. I do not need to tell you that jeopardising the credibility of monetary policy will do absolutely nothing to preserve the stability of the euro.

This leads to a more general point. The crisis cannot be resolved solely by throwing money at it. While money can buy us time to tackle the crisis, it is imperative that we use that time in order to address its root causes. This approach is, by the way, fully in line with one of the priorities defined by the Mexican G20 presidency: "Economic stabilization and structural reforms as foundations for growth and employment".

Regarding the situation in the euro area, three things have to be done. First, the member states have to restore confidence through fiscal consolidation. This is unavoidable and, given the dire state of public finances, less contractionary than is often assumed. Conversely, criticising the German authorities for not using their alleged "fiscal space" is quite inappropriate. Since the spill-over effects of German fiscal policy on the peripheral countries of the euro area are quite limited, the benefits would be much smaller than the harm of compromising the consolidation course.

Second, some member states have to boost their competitiveness and their potential for growth through structural reforms. In this regard, we have seen some promising signs during recent weeks. Third, we need rules ensuring stricter fiscal discipline in the future. Some progress has been made with recent amendments to the SGP, the so called "six pack", and the fiscal compact. But given past experience, rigorous implementation of the new rules is crucial. Germany has set an example by introducing a national debt brake in 2009. It now has to set an example by actually sticking to these new rules.

Finally, we have to further increase the resilience of the financial system. This is surely one of the global lessons we have learned from the financial crisis, but it is especially important in the context of the euro area, where contagion spread primarily through the financial system. Therefore, it is essential to ensure that agreed financial reforms are implemented rigorously, in a timely manner and in a way which promotes consistent results. We must not lose momentum in completing the first round of financial regulatory reform since the start of the financial crisis, and I am glad that this is one of the priorities of the Mexican G20 presidency. It goes without saying, however, that financial regulatory reforms will – by their very nature – never be definitive or conclusive.

5. Conclusion

Ladies and gentlemen, let me sum up the main points of my speech. I talked about two peculiarities of EMU that contributed to the sovereign debt crisis – the most important one being the combination of a single monetary policy and national fiscal policies.

I argued that higher "walls of money" can buy time, but that time must be used to tackle the roots of the crisis. This includes consolidation of public finances, structural reforms and better rules at the European level. Germany has been a stability anchor in containing the crisis by supporting the various rescue mechanisms, but the conviction that tackling the structural causes of the crisis is both indispensable and holds out the promise of success has been the essence of the German position throughout the crisis.

In this regard, we have seen some progress over recent months. Nevertheless, success depends on rigorous implementation of the agreed measures and rules. Personally, I am confident that, by following this course, we will eventually contain the crisis and that the euro will remain a stable currency.