Jens Weidmann: Everything flows? The future role of monetary policy

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the 2012 ZEW Economic Forum, Mannheim, 12 June 2012.

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1. Introduction

Professor Franz,

ladies and gentlemen,

I am delighted to be able to speak to you here today at the ZEW Economic Forum. Professor Franz, thank you very much for the invitation.

At first glance, the title may have left a few of you slightly puzzled. “Everything flows? The future role of monetary policy” conjures up a number of associations.

The title could be alluding to the massive increase in liquidity as a result of non-standard measures taken by many central banks.

Some of you may also have thought of the pre-Socratic philosopher, Heraclitus, who is known for his dictum of constant flow and the passing of all things. “Everything flows” thus also refers to changes in the role and general conditions of monetary policy.

Both associations are correct and are inter-connected. The central banks’ contribution to combating the crisis is one of the reasons why the current role of monetary policy is being debated so intensely. This is true across the globe, but especially in the euro area with its specific set-up and the unique situation posed by the sovereign debt crisis.

There is no doubt that the crisis has delivered important findings for monetary policy and for monetary union. However, my key message today is to make clear that the paradigms that have been valid to date have by no means suddenly lost their validity. On the contrary, given the challenges that we are facing today, we should not recklessly throw long-held principles overboard and turn our backs on the lessons from the past.

Ultimately, monetary union in its current institutional form was created as a result of lessons learned from past errors. And by that, I do not so much mean German hyperinflation at the beginning of the 1920s, as is all too often assumed by foreign observers. Instead I mean the monetary policy experience gained in the 1970s and 1980s with the extremely heterogeneous development of inflation in Europe. Countries with politically independent central banks and a clear primary objective of price stability, such as Germany, had much lower inflation rates than countries in which central banks were obliged to follow politicians’ instructions and were additionally called upon to pursue fiscal and economic policy goals. This is one of the reasons why the Bundesbank, with its culture of stability, was chosen as a founding model for the Eurosystem.

An independent central bank is necessary for stable prices, but more than that is needed. Price stability is also jeopardised by unsound public finances. If public finances get out of hand, the central bank can come under overwhelming pressure to jump to fiscal policy’s rescue and, in so doing, can undermine its primary objective of price stability.

This lesson is not just derived from theoretical models, it has been evidenced time and time again in the past. A particularly good example from history is the Latin monetary union comprising Italy, France, Belgium, Switzerland and Greece. Even before the treaty of union came into force, Italy’s debt exploded owing to the war with Austria. On 1 May 1866, the government took out a loan with the Banca Nazionale to finance this debt for which Italy departed from the bimetallic standard and imposed an enforced rate of exchange for its banknotes. This enforced monetary financing of war debts triggered the first severe crisis of the Latin monetary union and fuelled a permanent mistrust between the member states.

The recent past – notably the financial crisis – also has important lessons for monetary policy. One example is asymmetrical monetary policy, which provides strong counter-measures when speculative bubbles burst. This can inflate the risks for financial stability. In an environment where market participants can pocket the full return on a risky investment if it is successful but only have to bear part of the costs if it is unsuccessful, risk appetite can take on a harmful dimension for the economy.

When considering the future role of monetary policy and its relation to other policy areas, we do not have to go back to the drawing board but can draw on a wealth of experience and economically proven evidence. This we can do, and this we should do. Although the outstanding political significance of the monetary union was – and still is – undisputed, a political project must also be economically sustainable; in the long term, it cannot be enforced against economic conditions. Economic mechanisms, such as the risk of moral hazard, may not be laws of nature; however, they are relevant constraints which politicians cannot ignore forever.

Thus, in order to overcome the crisis and to prevent it from happening again, it is essential to apply a coherent approach: the short-term emergency measures and institutional changes must not stand in the way of the long-term stability objective. And the interaction between monetary policy, financial stability measures and fiscal policy must be compatible with the special conditions of monetary union.

This coherence is currently not given. However, I do not see the deficits so much in the area of monetary policy. Its commitment to the primary objective of price stability has proven its worth and must therefore be upheld, especially in view of the increasing efforts for the mandate to be expanded. Nevertheless, a deep rift has developed in the fiscal and economic policy foundation of monetary union. This foundation emphasises member states' individual national responsibility and sovereignty, which is, however, being increasingly undermined as a result of the progressive communitisation of risks. It is here that I see a need for adjustment and the need for Europe to make a pivotal decision, which can no longer be delayed.

It is for this reason that the topics of fiscal union, deeper integration and political union are currently on everyone's lips. In the following, I will therefore be focusing on the fiscal and economic policy foundation of the euro area in particular. But first, I would like to begin by taking a short look at monetary policy and financial stability policy.

2. Core function of monetary policy in relation to financial stability

There is currently no lack of suggestions with regard to adjusting the pre-crisis monetary policy consensus to the supposedly new circumstances. The bottom line of much of the advice directed at central banks is that they should raise their inflation target. Although the benefit of low inflation rates is not being questioned as such, it is suggested that, given that other policy areas have been pushed to their limit, monetary policy, too, ought to contribute to reducing debt and the imbalances in the crisis countries by means of higher inflation rates.

To cut a long story short: such an approach is completely unsuitable as a solution of these problems. Besides, the price to pay would be far too high, namely the loss of credibility of monetary policy as the precondition for price stability. Placing confidence in central banks is the solution to the time inconsistency problem of monetary policy, and this confidence is like confidence in general: it takes a great deal of time and effort to build up and from a certain point can be easily squandered. However, it is this confidence that forms the basis for public acceptance of monetary union. Discussions on the benefit of higher inflation targets or expanding the monetary policy mandate – as fruitless as they may be – put this confidence at grave risk.

The commitment of monetary policy to the primary objective of price stability is a historical achievement and it must not be compromised. Instead, monetary policy must combat future upside inflationary risks with tenacity. The steps necessary to achieve this objective must not be impeded or delayed by other considerations that are irrelevant to monetary policy. This applies also, and especially, with regard to ensuring financial stability.

An unstable financial system impairs the transmission of monetary policy and can jeopardise price stability without these dangers being reflected in inflation expectations or measured inflation in good time. But as important as financial stability is, what are the implications for monetary policy?

I am convinced that the decisive contribution by monetary policy to financial stability is and remains price stability, whereby a longer-term outlook has become even more important. Monetary policy must look beyond the cycle. It must not succumb to a purely short-term crisis logic and thus create new risks to the stability of prices and the financial system.

Conversely, financial stability policy requires its own macro-prudential instruments. Previous unsound developments in individual countries of the monetary union show that these macro-prudential measures must also be applicable at the national level – regardless of their compatibility with Europe as a whole. Central banks will play an important institutional role in this area in future. This means specifically that there will be no renationalisation of monetary policy. Instead, a successful financial stability policy takes the burden off monetary policy, allowing it to focus on maintaining price stability.

In view of the extent of the risks and the contagion effects in the crisis, there have been loud calls for integration of financial stability policy in Europe to the point of a common deposit insurance and resolution system as well as a banking union. The question is essentially this: if we are all in the same boat with regard to bearing the burden, would it not be better to jointly monitor the risks and to properly regulate the issue of joint liability in advance?

Given the cross-border banking structures and contagion effects, it is essentially a good idea to Europeanise financial supervision, and this is already taking place – two of many examples are the European supervisory authority EBA, which has already taken up its work, and the recent Proposal for a Directive made by the European Commission for designing restructuring and resolution regimes. There is more to a banking union than that, however. The aim is not only a better prevention of crises, but also the ability to cope with crises in fiscal terms, which means money – and not a small amount at that. The degree of Europeanisation of financial stability policy is closely linked to the Europeanisation of fiscal control and intervention rights in this connection, if not inseperable. This is where I see the greatest challenges – for monetary policy and the entire monetary union alike.

3. On the financial and economic foundation of monetary union

The crisis has exposed the weaknesses of monetary union. Some member states experienced severe unsound developments in their financial system, their national financial policies or their economic structures – unsound developments, which the institutional framework both failed to prevent and underestimated in terms of their impact. The foundation of monetary policy proved to be too weak. For this reason, the foundation must be strengthened and deepened in order for the euro area to remain a stability union and to regain confidence.

This requires clarity as to what the objective of monetary union should be and how to achieve it. Clarity especially in terms of the depth of integration we are aiming at and any transfer of responsibilities from the national to the European level that this entails. We must find a framework that is coherent in itself and that clearly allocates responsibilities. Clarity and confidence require political consensus which must, above all, be borne by the approval of the public and the design of the treaties and constitutions. This is the only way in which a solid foundation can be created, upon which a stability union can then be based. If the foundation is incomplete, brittle or threatens to be undermined, confidence is destroyed. Policies can of course try to mend the cracks in the building or support those parts in danger of collapsing. However, nobody will feel safe inside such a building anymore.

In principle, there are two approaches to achieving a stable monetary union. First, the member states could return to the principles stipulated in the Maastricht Treaty and their current constitutions, where emphasis must be put on both sides of individual responsibility – making their own decisions and bearing the consequences themselves. The guiding principles here are national sovereignty and subsidiarity. Fiscal and economic policy thus remains chiefly a national responsibility, as does the stability of national banking and financial systems. A strict framework and interest rate premiums to be paid on the capital markets ensure that incentives are in place for member states to pursue stability-oriented policies. There is no place in such a scenario for far-reaching joint liability.

In this approach, the current framework can also be strengthened by intensifying crisis prevention measures. This comprises, in particular, a macroeconomic surveillance procedure, as is currently envisaged, and tighter restrictions for fiscal policy, including improved monitoring and implementation. The aim of lowering deficit and debt quotas has to leave the page and become a reality. This is the only way that public finances can absorb macroeconomic shocks without endangering a state's solvency. Furthermore, it is essential to make the financial and banking system significantly more robust in order to limit contagion despite ever closer financial ties. This necessitates further improvements to regulation and financial system supervision, and a much greater resilience to crises. If properly designed, a crisis resolution instrument, such as the ESM, can provide a vital contribution to stabilisation.

All in all, I do, however, currently see the danger that joint liability is being extended, with the result that the existing institutional framework is being clearly stretched, but with the possibilities for control and intervention lagging behind. This poses an acute threat to the balance between liability and control. Whereas, for instance, the fiscal compact aims to ensure more stringent prevention measures, the clear wish to forego risk premiums if aid programmes are made use of significantly weakens the incentives for sound public finances.

The alternative to a "return to Maastricht" is the transition to a true fiscal union, which is currently the subject of intense debate. This idea is nothing new. This issue was a topic of debate at the Bundesbank long before monetary union was even established, and this issue was again raised during the financial crisis.

Allow me to make one preliminary remark before I move on to discuss the individual aspects of a possible fiscal union in greater detail. "Fiscal union" is a difficult term to pin down and can take a number of forms. Provided it is adequately structured, a fiscal union can prove to be the cornerstone of a coherent institutional framework for the monetary union. However, even such an ambitious project as a fiscal union can by no means solve the problems that many countries are facing today: high unemployment and a lack of competitiveness are not going to disappear overnight. The need for adjustment would still exist and given the strong interdependencies, it would probably require an even closer oversight with regard to the macroeconomic imbalances in the member states. Above all, however, the transition to a fiscal union would by no means guarantee a stability union. The crucial point here, in addition to an adequate structure, would be that a common European stability structure be developed and actually implemented.

Irrespective of all the changes to the regulatory framework, in a fiscal union, those countries which are experiencing macroeconomic or financial imbalances would consequently have to implement structural reforms to put their public finances in order to get the economy back on its feet. Depending on the form that it takes, a fiscal union could contain substantial transfer components. I am, however, convinced that most of the euro-area public would not accept simply glossing over the structural problems in individual countries by means of transfer payments, especially as it is more likely that the problems would just become further entrenched.

The focus of the debate has quite legitimately been the issue surrounding joint liability. The idea that the introduction of such a measure alone will be the solution to all the current problems is just as delusional as the belief that the introduction of a single currency is an automatic guarantee for economic prosperity in the individual member states. Such measures may well help to cover up unsound economic developments for somewhat longer, yet the underlying economic issues cannot be rectified in this way. On the contrary, an expansion of joint liability is therefore not the answer to the spectre of reform fatigue in Europe. The disciplining effect on the financial markets would consequently be undermined and the incentive for reform would diminish in countries where there is need for adjustment. This would do away with an important corrective for national economic policy, and would be a severe blow to Europe's economic outlook in a globalised world and to a stability-oriented monetary policy. Furthermore, the creditworthiness of the countries providing assistance would also be put at risk. In addition, political acceptance would be lost in these countries as a result of perceived excessive demands and excessive advantages. The monetary union would consequently lose its anchor and thus its basis for any kind of stability. These medium-term risks must not be brushed aside in favour of a short-term easing of the acute and fragile economic situation.

Joint liability can therefore only be introduced at the end of the integration process of a fiscal union and not at the beginning. Rather, it must also succeed, especially in a fiscal union, in maintaining and strengthening the incentives for necessary economic reforms and fiscal consolidation. And this can also succeed if, as I have already mentioned, liability and control are brought back into line and a fiscal union is structured in a manner than is compatible with stability.

Not surprisingly, it is precisely in those countries which face acute financing problems and a severe loss of confidence in their own fiscal policies that the cries for joint liability are the loudest and the most emphatic. The support we are seeing from the European institutions, which, by their very nature, advocate greater centralisation at the European level, is just as understandable.

It is, however, worth noting that the advocates of joint liability are often in those countries which are the most opposed to surrendering their national sovereignty with regard to financial policy decisions. It is clear that joint liability holds the promise delivering benefits and extending a country's scope for action, whereas fiscal union could restrict the scope for action at the national level. As understandable as such a stance may be, a stable union cannot be founded on this basis. My impression is that Germany is much more open with regard to the issue of surrendering national sovereignty than many partner countries.

In order to establish a stability-oriented fiscal union, it is my firm belief that it is imperative for the euro-area countries to summon up two things

- First, the willingness to submit themselves in a binding manner to strict budgetary rules.
- Second, the willingness to hand over sovereignty in some areas to a central level that effectively monitors compliance with the rules and, above all, can enforce them.

Consequently, although not necessary, it would be acceptable to bear risks to a certain extent jointly. In this context, the sequence in which the steps are taken is crucial. If we were to reverse the order, there would be a risk – if not, in fact, a strong probability – of the second step never being taken or, at least, not being taken properly.

But how might a stability-oriented fiscal union be structured? There are, of course, a large number of options for this, all depending on how far competencies are shifted to the European level, revenue and spending powers are centralised and transfer elements are extended. I wish to assume the status quo; in other words, as much subsidiarity as possible in the form of national fiscal responsibility and the fiscal objectives, as set out, for example, in the Stability and Growth Pact and in the fiscal compact. And it is on this basis that I would like to outline a number of minimum requirements for a stability-oriented fiscal union.

This minimal approach has the advantage that it allows a broader range of economic policy cultures in the member states, since the further integration advances, the less room there will be for differences in the concept of statehood, the social security systems or pay negotiation structures. Let us not be under any illusions: there still exist major differences in that respect, even between Germany and France. In Germany, government spending is 46% of nominal GDP, whereas the figure for France is 56%. And while Germany has responded to the demographic challenges with a phased increase of the retirement age to 67, a recent increase in the retirement age from 60 to 62 in France is to be reversed again in some cases.

The core element of such a fiscal union which is limited to the absolute essentials consists in strict and effective budgetary rules that set a binding ceiling on national borrowing. Given experience of the past few years, this would not be monitored by the European Commission or the Ecofin Council, but ideally by a new, independent euro-area institution. In the event of a country not abiding by the budgetary rules, national sovereignty would be automatically transferred to the European level on a scale that can ensure compliance with the objectives. In a speech at the Petersen Institute, Jean-Claude Trichet, the former President of the ECB, described this aptly as "federalism by exception". One option, for example, could be the right to make tax increases or proportional cuts in expenditure – and not just the possibility of calling for them. In effect, national sovereignty would be largely retained and fiscal policy decision-making capabilities and room for manoeuvre would be preserved as long as a country in question complies with the limits on borrowing and debt. In that kind of framework, consolidation paths would be safeguarded at the European level even if no majorities were to be found in the relevant national parliament.

Along with the credible establishment of such a framework which reliably safeguards compliance with the fiscal rules, a joint liability of the euro-area member states could be introduced, say, by issuing jointly guaranteed or partially guaranteed bonds or by a bank union that comprises key elements of a joint liability.

A stringent fiscal union on these lines is fundamentally suited to placing monetary union on a strong, enduring foundation. As time goes on, this union also has to be lived as a stability union. Before arriving at the goal, however, two obstacles, to which I alluded earlier, have to be overcome.

First, a fiscal union has to be equipped with comprehensive democratic legitimacy. It is a matter of a quantum leap. European integration would be noticeably extended, and national sovereignty and self-determination would be handed over. What is crucial for this to happen is democratic legitimacy given by a clear manifestation of the will of the general public in all of the affected member states. This is the only way to create the confidence that the new framework has popular acceptance and backing and will therefore endure.

The second obstacle, which is linked to the first one, is the far-reaching amendment of the European treaties and national constitutions. This is necessary because fiscal union is not envisaged or is expressly forbidden in the existing legal framework. The aim of the amendments is to create a reliable and stable structure that cannot simply be changed yet again in the short term. An established and respected legal framework is a key precondition for the stronger integration of very different nations. This process requires a certain amount of time, but is indispensable. This is because a fiscal union which lacks transparency, which is introduced by circumventing existing regulations and standards, or which is left to the whims of everyday politics would be built on sand and not be a sustainable basis for a stability union.

Democratic legitimacy based on broad public support and amendments to the legal framework are closely linked. While joint liability, for example, is irreversible, changes to the EU fiscal rules might be put up for negotiation at any time. Examples of this are the experiences in dealing with the rules of the Stability and Growth Pact as well as the concrete design of the fiscal compact, which has fallen short of the goals that were originally set.

Above all, Germany will have a perceptible stability contribution to make given a further step in integration. The recent past has shown, however, that, in monetary union, Germany's interests are protected by existing treaties and a German veto. From a German perspective, it is therefore crucial that there is a consensus in adopting the cornerstones of a stability-oriented fiscal union and that, once they are agreed, they are secured in such a way that they endure and cannot be changed yet again by majority decision.

By outlining these caveats, I am by no means arguing against deeper integration, quite the opposite. But just as the existing decentralised framework of the euro area has had its shortcomings, deeper integration by itself is not a guarantee of a stable monetary union – especially not if you take the second step before the first. A stable monetary union does not depend on the "United States of Europe", but without a stable currency and a matching fiscal framework there will be no permanent stable political union.

4. Conclusion

Ladies and gentlemen

I have covered a broad range of topics in the past half-hour.

The role of monetary policy is changing, but it is far removed from having to change fundamentally. It is more the case that it has to resist stronger encroachment – the guiding principle is "course correction, not going into reverse". The fiscal and economic policy framework of monetary union requires far more amendments. Europe is faced with a pivotal decision on how a stability union is to be preserved, and has to engage in a public debate on precisely the politically unpleasant questions. As in monetary policy, responsible action also means heeding the lessons of the past and not repeating earlier mistakes – especially in times of upheaval.

This message may appear simple, perhaps even dull. I nevertheless find it helpful and important. If everything flows, as in the current situation, you should not simply let yourself be carried along by events. It is precisely in times like these that it becomes even clearer what gives support and what has permanent value.

Thank you for your attention.